103

SMALL BUSINESS AND THE INTERNATIONAL ECONOMY: CONDITIONS FOR OPERATING AT HOME AND ABROAD

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, WEDNESDAY, MAY 26, 1993

Printed for the use of the Committee on Small Business

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WEDNESDAY, MAY 26, 1993

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SMALL BUSINESS AND THE INTERNATIONAL ECONOMY: CONDITIONS FOR OPERATING AT HOME AND ABROAD

WEDNESDAY, MAY 26, 1993

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order.

The Committee on Small Business meets today to hear from the Under Secretary of the Treasury for International Affairs, Dr. Lawrence Summers.

The critical importance of exchange rate and macroeconomic policies for U.S. business operating at home and abroad cannot be underestimated. In most big businesses, most multinational corporations, they are able to deal with these issues. Small businesses very often cannot really participate and deal with them, or handle them quite as well. Yet it has a profound impact on small businesses as well as large businesses.

That is why I feel it most appropriate and necessary that the small business community be as concerned about these issues as the big business community. That is why we are having the hearing today. It is propitious, too. The Senate Banking Committee had a hearing on this issue yesterday, I understand.

The 1988 Omnibus Trade Act requires, in a provision that I authored, that the Treasury report to the Congress every 6 months on foreign exchange market developments. Treasury has been called upon by statute to provide an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets including bilateral trade and capital flows.

Yesterday, Treasury released its most current report, and we look forward to hearing from Dr. Summers on the Treasury's evaluations of these current developments.

There are many issues that we wish to go into. I will not read my entire opening statement at this point in time. I will ask unanimous consent that it be put into the record.

Without objection, so ordered.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. I would ask the ranking minority member if she has any statement she wishes to make?

Mrs. MEYERS. Just very briefly, Mr. Chairman.

I am very glad that you are with us today, Dr. Summers. While the topic of today's hearing is intellectually interesting, I am not certain that many small businesses would consider exchange rate manipulation a key impediment to exporting. I am very interested to hear what you have to say.

Maybe there is something here that I am missing, but I am also a member of the Foreign Affairs Committee and serve on the subcommittee which has jurisdiction over economic policy and trade. Throughout my years on this committee and on Foreign Affairs, I don't ever recall having been contacted by an exporter who insisted that some other nation's exchange rate policies were a major impediment to exporting.

The major impediments to small business export activities are obtaining financing for their exporting efforts and the regulatory and paperwork burdens both in this country and abroad. Until we address these hurdles facing small business exporters, our inquiries into such areas as G–7 monetary policy and exchange rate movement may be a bit premature in serving a really beneficial purpose for this Nation's small businesses.

However, I do look forward to hearing what you have to say, and maybe there is an application here that just has not affected the businesses that have contacted me or that I have contacted.

Mr. Chairman.

[Mrs. Meyers' statement may be found in the appendix.]

Chairman LAFALCE. Does anybody else have an opening statement?

Mr. RAMSTAD. Mr. Chairman.

Chairman LAFALCE. Yes.

Mr. RAMSTAD. Very briefly, Mr. Chairman, I ask unanimous consent that my entire statement be printed in the record.

Chairman LAFALCE. Without objection, so ordered.

Mr. RAMSTAD. Mr. Chairman, I am pleased to have Dr. Summers here this morning to discuss current economic conditions.

I found your testimony yesterday, Dr. Summers, before the Senate Banking Committee very interesting. Some of the statements were encouraging. Others, I look forward to discussing with you today.

I certainly share the commitment of the administration to free trade, and I sincerely hope the President is committed to the successful completion of the Uruguay Round of GATT talks.

Like the President, I am also a strong supporter of NAFTA. I believe NAFTA, as originally drafted, will promote even greater export growth and economic prosperity for our workers and our companies.

But I am concerned about some of the pending side agreements, and I trust that we can discuss some of that subject matter today.

Again, Mr. Chairman, Dr. Summers, I look forward to our exchange today and to your testimony.

[Mr. Ramstad's statement may be found in the appendix.]

Chairman LAFALCE. I wasn't going to read the entirety of my statement, but given Mrs. Meyers' comments, I feel it necessary to at least make some statements.

I believe that there is a direct relationship between exchange rates and the ability of U.S. businesses to export abroad. There is also a relationship between the ability of exporters in other countries to sell their products in the United States. I have, in fact, received correspondence on this issue and its impact on small business, I will submit for the record an example of a letter from a concerned constituent.

[The letter may be found in the appendix.]

Chairman LaFalce. I think it is important that we not have volatility in the exchange rate markets. What the appropriate relationship should be is often a very difficult thing to focus in on, and I think stability is very important.

I represent a community that has four bridges crossing over into Canada, and I recently participated in a Canadian-American interparliamentary conference. I asked my staff to present a flow chart of the Canadian dollar vis-a-vis the U.S. dollar and also to show the various trade balances that we were running.

There is a perfect symmetry, a perfect symmetry, between the changes in the exchange rate and the changes in our trade balances. It has a profound impact.

So, it is probably much, much more important in my judgment to the extent we want to export than is the issue of regulatory burden; although, that is an extremely important issue also. I don't mean to minimize the importance of that issue, nor do I think anyone should minimize the importance of this issue. It is extremely important.

Perhaps, as is appropriate within your testimony, Dr. Summers, you might like to address the issue of the importance of exchange rates within the context of America's competitive posture as a trader around the world.

But having said that, I call upon you to make any statement you would care to make.

TESTIMONY OF LAWRENCE SUMMERS, UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Dr. Summers. Thank you very much, Congressman. It is a pleasure to be here today to present the Treasury's latest report on international economic and exchange rate policy. I have a prepared statement for the record, so I will just summarize some of the key points.

Chairman LaFalce. Without objection, we will put the entirety of Dr. Summers' statement in the record.

Dr. Summers. In a sense, the title of this report is an anachronism. It is an anachronism because it is no longer possible to distinguish domestic from international economic policy.

Our prosperity is linked to the maintenance of a strong world economy, an open trading system, and stable financial markets. We made a beginning at home with the President's program of deficit reduction and economic revitalization. It has enhanced, and will further enhance when it is passed by the Congress, U.S. credibility with our G–7 partners. It is paying dividends in the form of lower interest rates and in the form of greater capacity for the United States to lead abroad.

Failure to implement that program would, however, have serious consequences for our international standing and could cause interest rates to rise and the recovery to falter, particularly in the context of a major U.S. Program to bring down the budget deficit and strengthen our economy, which corresponds to what foreign governments have been asking us to do for some years.

The need for effective G–7 coordination has never been greater. The industrialized countries are in the third year of subpar growth, and the prospects for sustained recovery in many countries remain uncertain.

Japan's latest stimulus package is a useful first step. It needs to be sustained so that domestic demand-led growth can occur and reduce Japan's large external surplus. The guidelines for the fiscal 1994 budget now being developed in Japan will, we hope, reflect a continuation of the stimulus effort contained in the April package.

In this regard, I should say that, in discussions that took place yesterday, the message of the exchange rate report apparently did not come through clearly. There was absolutely no intention to signal any alteration of U.S. policy toward exchange rates. U.S. exchange rate policy remains as described by Secretary Bentsen, that exchange rates should reflect economic fundamentals, that attempts to artificially influence or manipulate exchange rates are inappropriate, that excessive volatility is counterproductive for growth, and that we should cooperate closely in exchange markets with our G–7 partners.

In line with this policy, the United States is not seeking further appreciation of the Japanese yen.

[Reaction by press representatives.]

Dr. SUMMERS. In Europe, that is a predictable consequence of the wire services to statements like the one I just made. Congressman, those are the wire services.

Chairman LAFALCE. Just a second now.

Would the stenographer read back, please, the last several sentences.

[The requested material was read.]

Chairman LAFALCE. Now, Mrs. Myers, if you have any doubt whatsoever about the relationship of our currency to the currencies in the other countries, its impact on the business community, let there be no doubt.

Mrs. MEYERS. Well, Mr. Chairman, I have no doubt that our exchange rates are extremely important. There is no question about that.

It is just that I am unsure sometimes how to relate this to small business exporting. In contacting the small business groups, this, as a concern, does not even show up on their radar screen. They are much more interested in barriers in other countries.

But there is no doubt in my mind that this is important, and certainly the latest exodus will prove it.

Chairman LAFALCE. We will discuss some of these barriers. One of them can be manipulation of exchange rates in other countries, too. We will be going into that, especially with respect, say, to China.

But please continue, Dr. Summers.

Dr. SUMMERS. Thank you very much. I wonder if they are worried if they are going to miss something.

Slower growth in Europe continues to be a critical problem, with the likelihood that European GNP, in real terms, will actually decline this year including over the next several months.

There have been some favorable developments in recent months—reductions in the rate of inflation, some favorable wage settlements, an increase in credibility following the French election—that enabled the spread between French and German interest rates to decline.

But high interest rates remain a matter of real concern in Europe, and we hope that, as rapidly as possible, the preconditions will be laid for lower interest rates and accelerated growth in Europe.

Clearly, one cannot think about the problems of Europe without recognizing the need for structural reforms, particularly in labor markets. Global growth is essential to the United States' economic strategy, because only through global growth can there be rapid increases in U.S. exports, which are an essential engine of growth for our economy.

So, coming into the G–7 Summit, we will regard restarting global growth as a major priority.

I want, also, to speak about the specific question of exchange rate manipulation. Use of the exchange rate in payment systems by major U.S. trading partners to impede imports are also a potential constraint on our economy.

In our continuing review of newly industrialized economies in Asia and China, Treasury has concluded that China manipulates its foreign exchange system in a manner that affects balance of payments adjustment. China has continued to sustain a trade surplus with the United States, and its bilateral surplus with the United States grew to over $18 billion dollars in 1992.

These outcomes, as well as our review of the pervasive and inflexible restrictions that limit access to foreign exchange on the part of those in China who would otherwise import U.S. products, underlie our conclusion.

As I have stressed in my talks with Chinese officials about the question of exchange rate manipulation, the recent narrowing of China's global surplus does not suggest that this problem is going away. Rather, it reflects the overheating of the Chinese economy. The recent trend toward a declining trade surplus will probably be reversed as growth drops to a more sustainable rate in China, unless, of course, a liberalized foreign exchange regime is put in place.

You will note that we no longer find that Taiwan is a currency manipulator. Taiwan does still have global trade and current account surpluses, but they have declined considerably. Also, Taiwan does not appear to be intervening in the exchange market or using its controls on capital inflows to prevent the Taiwanese dollar from appreciating.

Nonetheless, authorities have retained the tools that have been used in the past, and Treasury will monitor their policies closely. We will be seeking further liberalization of the Taiwanese exchange market.

That concludes my remarks. I would be happy to answer questions.

[Dr. Summers' statement, with attachment, may be found in the appendix.]

Chairman LAFALCE. I am tempted to say, for the returning press, I am glad that you corrected your earlier statement. But for fear of causing worldwide havoc, I won't.

Let me just ask you a basic question. You are a professional economist with great academic credentials. To the extent the small business community is interested in exporting, how important is the relationship between our dollar and the currencies of the countries that we wish to export to in enhancing or detracting from our ability?

Dr. SUMMERS. I could rather answer the question, Congressman, in broader terms.

Chairman LAFALCE. Surely.

Dr. SUMMERS. I think experience suggests that it is much easier for us to export into growing markets than into shrinking markets. Because in growing markets the demand—the pie is expanding. Because in growing markets it is easier to support measures directed at liberalization.

So, it is for that reason that I think our small businesses, like our big businesses, have a very strong stake in a rapidly growing global economy. The proper management of exchange rates, the maintenance of a measure of stability, can make an important contribution to sound and general growth in the world economy.

While that is not an individual, proximate barrier that comes first to the mind of individual small businesses that think about what is happening to them, I think that, over time, international economic policy and the extent of growth in the global economy do have a quite substantial impact on the fortunes of businesses, both small and large. It is for that reason that I think international economic policy really is critically related to domestic economic policy.

Chairman LAFALCE. All right. I personally think it is extremely important that there be stability in exchange rates. I think you concur with that. You said it in your opening statement that we not have wild swings, that the relationships stay within a certain band, if you will, a certain float. What that should be and how it should stay within that range is a separate question. The process for getting or keeping it there is separate from whether it should be there.

But I think this is especially true whenever we try to bring about what is tantamount to a merger of economies. So, therefore, it is especially true with respect to the European Community, and it is especially true with respect to the United States and Canada because of our free-trade agreement. I think it will be more true in the future than it has been, historically, should we enter into a NAFTA.

Now, I utilized the economic stabilization subcommittee of the Banking Committee when I chaired it, and this Small Business Committee when I began chairing it, to aggressively promote the Canadian-American Free Trade Agreement. I thought at that time that it would be very wise to have a provision within the Canadian-

American FTA providing for some coordinating consultative mechanism with respect to our exchange rates.

This was proposed also by the Institute for International Economics in its report on the Canadian-American FTA, written by Dr. John Williamson.

I note that again, from 1988 to the present, you can trace the trade flows and the differences in the exchange rate in perfect symmetry. I am interested in that same subject but to a much greater extent with respect to Mexico, because, historically, we have not seen wide swings in the Canadian-American relationship; but we have seen enormous swings in the Latin American countries—and Mexico is one of them. From 1980 to the present, the Mexican peso has gone from around 25 to the dollar to about 3,200 to the dollar, using the old as opposed to the new terminology.

Without conceding the passage of NAFTA, would it not be wise to have some type of consulting, coordinating mechanism in place similar to the G-7 but this time it would be sort of the G-3, between Canada, the United States, and Mexico?

What do you think of that, Dr. Summers?

Dr. SUMMERS. Congressman, I think that the dialog on exchange rates of that kind certainly has gone on to some extent in the past between countries, and it will take on increased importance as the economies become more closely knit.

I think the experience in Europe over the last 2 years points up the difficulty of larger countries trying to underwrite fixed exchange rates or exchange rate regimes for smaller countries. I would be concerned if such discussion and dialog were to go so far as to create a system that might prove to be very difficult to sustain over time.

But I think the concept of periodic consultation on macroeconomic strategies is certainly something that is useful. The Canadians, of course, are included in the G-7 process; and there are periodic consultations between American and Mexican officials on a range of bilateral issues, of which macroeconomic policies certainly are one.

Chairman LAFALCE. All right. Good. Historically, there has been quite a bit of criticism from different economists, who you and I would both respect, with respect to the efficacy of the G-7 mechanism.

In an article in the March-April edition of the International Economy, Jeffrey Garten wrote a memorandum to President Clinton where he says:

> The current G-7 mechanism is in bad shape. We saw the beginnings of rigor mortis at the G-7 Summit in 1990. By London, the next year, gangrene had set in. At Munich last July the group was headed for the intensive care unit. The meeting of G-7 finance ministers, at the end of February, was a cordial get together but changed nothing. Now major surgery is called for.

Chairman LAFALCE. Well, of course, you had a subsequent meeting to that. You had a meeting at the end of April.

What are your thoughts, either about Professor Garten's statements, historically, or, if you want to stay away from that, what do you think of the ability of the G-7 to use that mechanism to enhance worldwide economic growth?

Is there a way it can be strengthened? What comments would you like to make about it?

Dr. SUMMERS. I am very happy with the way the G–7 process has been going since the Clinton administration came into office on January 20.

Within the first 100 days of the administration, we had three G–7 meetings: In London, in Tokyo in connection with Russian support, and in Washington in late April. Out of those meetings, I think the foundations for real progress have been laid. We have set a very different tone in those meetings than has been the case in the past. It is one of collegiality and mutual respect. It is supported by the fact that the United States, at long last, is moving to confront problems like the budget deficit that others have identified as crucial for international economic cooperation.

It is supported, I believe, by the approach that Secretary Bentsen has taken to the process. The idea of the process is not to pull rabbits out of hats at meetings. The idea of this process is really what happens between the meetings in terms of policies that are altered over time.

I think we have seen concrete results. We have seen a major—the largest in history—Japanese stimulus program. There is much more that needs to be done if domestic demand is to fuel Japanese economic growth and make possible increased imports and a reduced Japanese current balance.

Chairman LAFALCE. Are you familiar with the writings of Professor Thurow, where he says the Japanese just don't know how to stimulate their economy by domestic consumption? They have always done it differently by export promotion, and he was not sanguine about the prospects for a successful stimulus package relying primarily upon domestic consumption.

I think that is a fair characterization of his article.

Dr. SUMMERS. I want to be understood clearly. I think the measure that was taken by the Japanese Government is a useful step, but I certainly don't think that, by itself, it is adequate to bring about a period of domestic demand-led growth.

I certainly think that, in the past, Japan's economic growth has often been export-led, and that is why the current account surplus is so large. We are going to have to be looking for a period of domestic demand-led growth.

That is why we are placing such emphasis on expansionary fiscal policy, because experience suggests that expansionary monetary policy is also associated with export-led growth, whereas fiscal policy tends to be domestic-demand centered.

Chairman LAFALCE. Now, of course, we are emphasizing their expansionary fiscal policy with respect to the U.S. economy, which, other than Canada, probably is projected to be the most dominant of the G–7 economies in the next fiscal year.

We are not adopting an expansionist fiscal policy. We are adopting a restrictive fiscal policy in order to deal with the budget deficit. The hope is that, in doing this, we can engender greater credibility in the private sector markets, better confidence in the ability of Government to govern appropriately, permitting the Federal Reserve Board to adopt a more accommodating monetary policy, in-

terest rate policy, so that we can get our stimulus to both sustain and enhance the economic recovery.

In your judgment, should we fail to pass the budget package, what would you think the economic effects would be both domestically and internationally?

Dr. SUMMERS. I think the failure to legislate a program along the lines of the one the President proposed would have very serious consequences for long-term interest rates and, through the impact on long-term interest rates, for the pace of recovery in the United States.

I think higher U.S. interest rates would have adverse consequences abroad. Much more importantly, we would lose our position of leadership and our capacity to lead on issues like expansionary fiscal policy in Japan and bringing down interest rates in Europe. We would be very seriously compromised.

I think that the kinds of problems of the previous summits that you referred to in the article by Professor Garten have much less to do with the process—things to be solved by having a secretariat or having a somewhat different group of people around the table—and much more to do with the problems that a great nation had staying great on a shoestring in an environment of very large budget deficits and a sense that critical domestic problems were not being addressed.

I think that sense of domestic renewal, by budget deficit reduction, is a central element and is absolutely critical to our leadership in the world.

Chairman LAFALCE. Thank you.

One last question: You did say that, in your judgment, the judgment of the Treasury, that China was manipulating its currency. There is no question that manipulation is one of the primary reasons that we have, what is it, an $18-billion trade deficit with China?

It is my understanding that the President is going to be proposing continuation of most favored nation status with China. It is also my understanding that China is seeking entry into the GATT.

Now, there are different considerations both for MFN and GATT. But do you think that negotiations with the Chinese to bring exchange rate manipulation to an end might be appropriate as a precondition to either/or both of those?

Dr. SUMMERS. In the context of the GATT negotiation, we are very vigorously pursuing the question of Chinese exchange rate manipulation. I would be very surprised if China were to become a member of the GATT without very substantial progress in that area.

As our report explains, the Chinese exchange rate system really is a kind of tariff barrier or kind of quota barrier, because, essentially, it is impossible to get foreign exchange, except to purchase certain kinds of goods. So, potential U.S. exporters of other goods are put at a near fatal competitive disadvantage.

If you look at the growth in the U.S. trade balance, trade deficit with Japan, with China, what you are struck by is exports haven't grown very rapidly.

So, I don't think, unless a variety of other trade barriers that fall outside Treasury's jurisdiction come down, that it will be realistic to think about China in the GATT.

Chairman LaFalce. Mrs. Myers.

Mrs. Meyers. I thank you for being here, and I would like to say that in a few minutes I am going to have to leave for a markup. So, I am not running out to report to anybody or anything.

Throughout the 1980's, it was felt that the real cause of our growing trade deficit with Japan was due, in large part, to an undervalued yen and an overvalued dollar. The yen's gone up and the dollar's strength has receded. Yet, we continue to have a burgeoning trade deficit with Japan.

Could you discuss that? Why has not that change made the difference in the trade deficit that many economists thought it would?

Dr. Summers. I think the kind of correlation that you have just pointed up highlights certain fundamental propositions. You can't devalue your way into prosperity. There is no magic exchange rate bullet for current account balances, and it is a deluding yourself to think that there is.

The evolution of the current account balance between the United States and Japan or Japan's global surplus reflects a variety of factors. One very important factor is the slow growth that the Japanese economy has suffered in recent years, which has meant much slower growth in imports and, therefore, an expansion in the current account balance.

Of course, continuing restrictions on imports into Japan that our business community is concerned about represent another reason why that current account has failed to adjust.

Another factor you have to consider in looking at the Japanese current account surplus is oil prices. Because they are so heavily dependent on oil, the substantial decline in oil prices impacts on the current account balance.

So, I think there is no single factor that can explain the magnitude of the current account balance, but clearly the kind of high level it has reached and the fact that some experts are forecasting that it will increase further over the next year are obviously causes for concern.

Mrs. Meyers. I would like to comment also that I think certainly you are correct in stating that doing something about this country's deficit is extremely important to us in terms of international trade and in terms of our relationships with the other G–7 countries.

I had hoped that we could do it more by cutting spending than by raising taxes because I do think that raising taxes puts up certain barriers for exporters.

So, I am concerned about the Clinton budget package. I think he wants to reduce the deficit, as we all do; and that is very good. I just think he is going about it in the wrong way.

But I appreciate very much your being here today, Dr. Summers. I am sorry that I will have to leave at this time.

Dr. Summers. Thank you very much, Congresswoman.

Chairman LaFalce. Mr. Poshard, do you have any questions?

Mr. Poshard. Thank you, Mr. Chairman.

Dr. Summers, I noted in your testimony that you referred, as the administration has several times in the past couple of months, that we are experiencing a modest recovery but with inadequate job creation.

How is that? How are we recovering in the economy and yet losing jobs in the process or a slower recovery in the job side of the equation?

What accounts for that?

Dr. SUMMERS. I think the lack of jobs, Congressman, reflects two factors. First, this recovery is slower than past recoveries have been. It is less than half as rapid over the last eight quarters from the recession trough as the average recovery has been. Slower recoveries go along with slower job growth.

Second, despite the slow pace of the recovery, productivity growth has ironically recovered to a significant extent as businesses have cut costs, and, thus, you have seen more of the output growth come in the form of increased productivity and a little less of the output growth come in the form of increased employment than might have been expected.

Put those two factors together, and what you get is pretty poor job performance. I think the only thing you can do about it is seek to accelerate the pace of recovery. I think passage of the President's plan, with lower, long-term interest rates, will do that.

Mr. POSHARD. The Japanese have put forth a stimulus package for their economy.

How does that differ from what the Clinton administration is proposing for our own?

Dr. SUMMERS. The Japanese situation is rather different from ours. They start with a substantial budget surplus on a consolidated basis. They start with a ratio of national debt to income that is well under 10 percent compared to something just in excess of 50 percent here.

They start with a very substantial amount of economic slack, as measured by GNP, relative to its potential. They start with a budget that, except for a stimulus plan, would be extremely contractionary in its impact.

The stimulus plan on top of all that is a response to the output gap in Japan, the need for increased domestic demand.

Our situation is rather different. We have a legacy of large and continuing budget deficits. We don't have a trade surplus. We have a substantial trade deficit. We have long-term interest rates that, in real terms, are very high and, therefore, tending to choke off investment. We have a quite high initial debt ratio.

So, we don't have the room to think about fiscal expansion. What is necessary for us is to restore confidence by bringing down longer-term interest rates, as the discussion of the President's plan has done.

Mr. POSHARD. I know I have asked the question before, and I guess I still struggle with it in my own mind: How, in terms of international competition, we relate to countries with similar standards of living such as the EEC, Canada, Japan, or whatever; and how we propose to enact agreements like NAFTA with countries like Mexico, which has a much lower standard of living than

our own, and how will that ever accrue to our benefit without lowering the standard of living in this country?

How are we going to do that?

Dr. SUMMERS. I think the critical thing to recognize about NAFTA is that the right question may not be, can we afford NAFTA, but can we afford to reject NAFTA?

American tariffs on Mexican goods are already extremely low. Foreign investment is already in Mexico. There will not be large reductions in American barriers to the sale of goods produced in Mexico that will come from NAFTA.

There will be large reductions in barriers in Mexico to goods produced in the United States. Already the anticipation of NAFTA has moved our trade position with Mexico from a deficit of $5 or $6 billion to a surplus of $5 or $6 billion. The reason that has happened is that capital has moved into Mexico on a very substantial scale. Some of it is flight capital returning. Some of it is foreign investors going into Mexico to produce.

Those loans to Mexico, those investments in Mexico, make it possible for Mexico to import more than it exports, and that is why we are able to run a trade surplus with Mexico.

If NAFTA were to fail, what you would see is very little change in the openness of the American market to Mexico, but a substantial reduction in the openness of the Mexican market to the United States, and a substantial reduction in the flow of capital to Mexico financing American imports.

So, you would see America, once again, go back to running a trade deficit with Mexico. You would see job loss as a consequence of that.

Mr. POSHARD. I know our time is limited. I would like to get into that issue with you some more.

But I am interested—if I may ask one more question, Mr. Chairman—I am interested in some elaboration on your part in your testimony where you say that, "Moreover structural reforms, particularly in labor markets, in reference to Europe are required urgently to produce greater wage and price flexibility."

What are we talking about there? What sort of structural reforms in labor markets are necessary in the international community?

Dr. SUMMERS. In Europe, we are talking about changes in some of the restrictions that, for example, make it almost impossible in some countries and some industries to lay off anyone who has been hired, regardless of what discipline problems arise or what economic conditions bring.

We are also talking about improved training and matching programs in order to work particularly with those who once worked with the strong military arms and heavy industries that have become uneconomical.

We are also talking about reforms in social insurance schemes to make them a more positive force that promotes reemployment, rather than continued unemployment.

These are the kinds of measures that would fall under the structural umbrella.

Mr. POSHARD. Thank you.

Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Dr. Summers, in your prepared testimony, you, like most economists and most observers, talk about or explain the bond market's favorable behavior in terms of the interest rates, especially the narrowing of the spread between the long- and short-term rates and also the stock market's behavior.

In light of that, how do you explain yesterday's plunge to the lowest level since October in the consumer confidence index?

Dr. SUMMERS. I am an economist, not a psychologist. So, I am reluctant to try to make too detailed an explanation of that.

I think it reflects the disappointment that the recovery does not appear to have been as strong in the first quarter and in April as it had appeared that it would be late last fall when GNP rose at a rate greater than 4 percent.

I think it reflects some disappointment that the Congress did not pass the stimulus bill that the President had asked for and that you didn't have that kind of spending coursing through the economy.

I would say those probably were the two most important factors in the decline of consumer confidence. But, again, I would hesitate to hold myself out as an authority on that psychological question.

Mr. RAMSTAD. The other area I wanted to ask you briefly about, after your meeting last month with the Group of Seven, there was an article in the Wall Street Journal on April 19, 1993, and I am quoting now:

> The odd scene of the United States, with its crippling national debt, telling Japan, the G–7 nation with the healthiest balance sheet, to be more like us, wasn't lost on the Japanese, and many were still shaking their heads long after your plane——

Mr. RAMSTAD. Treasury Secretary Bentsen's plane; I assume you were on it.

> cleared the air space.

Mr. RAMSTAD. One official then said that there is a genuine feeling among the Japanese that they have done the maximum they can do in terms of creating domestic demand and in terms of increasing imports from the United States to reduce Japan's trade balance.

Do you believe they have done the maximum they can do?

Dr. SUMMERS. No; I don't. I believe that, as I said, the step they have taken is an important one; but that one needs to maintain some continuity if domestic demand is to grow and to drive the Japanese economy forward.

The Japanese current account surplus for the last several years has increased and, according to many forecasts next year, is going to increase further. What that means is that the global demand for Japanese goods is actually rising more rapidly than the domestic demand for Japanese goods. That is why there are more exports.

I think that, at this date, there is no reason why it is not reasonable to look to Japan to enjoy a period when the domestic demand for goods grows more rapidly than the economy's capacity to produce them, so you would see a reduction in the Japanese net exports to the rest of the world.

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I think it is possible for them to go further, but that is a thing that involves both macroeconomic elements and microeconomic elements, the kinds of fiscal policies we have been talking about, but also trade policies to open markets.

Mr. RAMSTAD. I appreciate your recognition of, certainly, that latter factor. Thank you, Dr. Summers.

Chairman LAFALCE. Mr. McInnis.

Mr. MCINNIS. Mr. Chairman, I will pass.

Chairman LAFALCE. Thank you very much.

Very often, within my lifetime, invariably, I should say, international transactions were often based upon U.S. dollar denominations.

I have noticed a trend, beginning developing trend, to look to certain international transactions based upon a yen denomination.

What is the reason for this? What is the significance of this? What are the implications of this short-term, to be sure, but especially long-term, should this continue and should the predominant domination of the future in international transactions be a yen as opposed to a dollar?

Is this something we should be alert to, concerned about?

Dr. SUMMERS. I think it is almost inevitable that, if you look at the period after World War II when the United States had half the world's income and was the dominant economy by far, the dollar would have had a kind of totally dominant role, but that you would expect it to recede somewhat as reconstruction in other economies was successful. Especially, given the kind of financial power that Japan amassed in the late 1980's during the bubble period, it was, I think, inevitable that there would be an expansion of yen—denominated financial instruments of various kinds.

Since the bursting of that bubble, there has actually been a reduction in the pace at which the proliferation of yen-denominated financial instruments has grown. I don't think that is a critical problem for the United States or for American financial interests.

What I think is absolutely critical is that we maintain the kind of discipline in our fiscal policies, in our monetary policies, in our domestic policies, that will enable the dollar to stay as a bedrock of the international monetary system.

I think that has to do, in part, with the macroeconomic policies that we follow. But it also has to do with the broad approach that we take to the world and the kind of doctrine that the President articulated at American University: That the United States must compete, not retreat, and that particularly in Asia, the United States must not withdraw. This is, I think, a very important aspect of international economic policy.

But I would be more inclined to see the kinds of changes you are describing as symptoms and consequences of other phenomena, rather than as the main issue in and of itself.

Chairman LAFALCE. I first became interested in exchange rates when I was trying to pursue, circa 1983, the formation of industrial competitiveness strategies for American industries.

It seems to me that we needed to take both a macroeconomic approach and a microeconomic approach. Many individuals criticized the efforts I made on a microeconomic level, saying the only problem we have is an overvalued dollar.

I think the fact that the value of the dollar has declined vis-a-vis most currencies, most especially the yen, mark, and others, was one of the reasons that it wasn't as important for the United States to get its microeconomic policies in order. It bought us time, if you will.

We also lost time in enhancing the competitiveness of our industries absent the reliance on a lower-valued dollar, while other countries, in order to compensate for the appreciation of their currencies, adopted productivity improvement measures, microeconomic policies that greatly enhanced their industries, solidified their industries.

I am encouraged that this administration sees the importance of microeconomic policies and appears to be making serious efforts to deal with those.

Do you think that analysis is fairly accurate, Dr. Summers? Is there any nuances you would like to add to it at all?

Dr. SUMMERS. I don't think there are any. I would subscribe, in particular, to your emphasis on the two blades of the scissors, macroeconomic and microeconomic policies. I think that is exactly the right way to think about it.

I can tell you that kind of thinking is reflected in the policies that are under development within the administration with respect to the question of our economic relations with Japan.

Chairman LAFALCE. All right. Now, I don't want to delve into the relationship between the United States and Japan in particular, but I just want to use it as an example. Circa early 1985, the yen was around 160 to the dollar. Now it is, what? about 110, give or take. I don't know what the latest is.

But I remember that American business used to say at one time, if only we had an appropriate relationship. I would say, well, what is that appropriate relationship? They would say, oh, 200 to the dollar.

Then when it became 200, some of the American businesses—well, it really should be 175, 150, or 125, et cetera, et cetera.

Now, rescinding from the question of the dollar-yen relationship but just in general, how does one find the appropriate relationship between two countries' currencies? What do we look to, to determine the appropriate relationship between the dollar and the mark, between the dollar and the franc, between the dollar and the peso or lire or whatever it may be?

What are the criteria to make a judgment on that?

Dr. SUMMERS. At one level, it is a very easy question to answer by saying that U.S. exchange rate policy is that exchange rates should reflect fundamentals and that it is a mistake to seek to artificially influence or manipulate exchange rates. What we are really saying is that we lack the capacity to make that judgment based on some analysis the Government can do or G–7 partners can do and that, instead, those are judgments that are made over time by markets as they see events unfold.

So one has to really ask, I think, the question: What are the fundamentals within the market that influence exchange rates, rather than taking a prescriptive approach about what exchange rates should be.

Factors that influence markets clearly include relative productivity levels, include the different stages in the cycle that different economies are at, and include structural differences in the propensity to save or the propensity to invest.

Chairman LaFalce. What if we were looking to something like the purchasing power of a country's currency for a particular basket of goods? Is that a relevant criteria?

Dr. Summers. Clearly, countries that inflate their currency lose value to purchase goods; and one expects that their currency loses value over time against other currencies.

I think that it is important, though, not to accept the simple doctrine of purchasing power parity as the characterization of exchange rates, simply because when you make purchasing power parity considerations, you look at so many goods; and exchange rates really are primarily influenced by goods that are subject to international trade. That is why experience suggests that the comprehensive purchasing power parity explanations don't really have a lot of power in explaining the fluctuations in exchange rates that take place.

Or, to put it in slightly more technical terms, many of the fluctuations in nominal exchange rates that take place also reflect fluctuations in real exchange rates and not just the purchasing power of money in different countries.

Chairman LaFalce. Very good.

Either Mr. Talent or Mr. Huffington, do you have any questions you would like to ask?

Mr. Talent. I appreciate the opportunity, Mr. Chairman; but I will yield back my time.

Chairman LaFalce. Thank you.

We have a recorded vote going on the floor of the House, Dr. Summers. This might be an appropriate time to thank you very much for your testimony, your report, and for your appearance before us today. Thank you.

Dr. Summers. Thank you very much.

[Whereupon, at 11:10 a.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN

COMMITTEE ON SMALL BUSINESS

HEARING ON "SMALL BUSINESS AND THE INTERNATIONAL ECONOMY: CONDITIONS FOR OPERATING AT HOME AND ABROAD"

MAY 26, 1993

The Committee on Small Business meets today to receive testimony from the Under Secretary of the Treasury for International Affairs, Dr. Lawrence H. Summers. The critical importance of exchange-rate and macroeconomic policies for U.S. business operating at home and abroad cannot be underestimated.

The 1988 Omnibus Trade Act requires, in a provision I authored, that the Treasury report to the Congress every six months on foreign-exchange market developments. Treasury must provide "an evaluation of the factors in the U.S. and other economies that underlie conditions in the currency markets including...bilateral trade and capital flows." Yesterday the Treasury released its most current report, and we look forward to hearing from Dr. Summers on the Treasury's evaluation of these current developments.

A number of exchange-rate conditions have important implications for international trade and financial markets. Appreciation of Japan's yen relative to the dollar--about 12 percent this year--has been criticized by the Japanese as "political speculation." Some argue that correcting the $49 billion U.S.-Japan trade imbalance through an appreciating yen is the wrong approach. They believe it will not shrink Japan's trade surplus, but ultimately could strengthen Japanese manufacturers by having them streamline operations, invest more heavily in Asia, and switch export markets to Asia. Indeed, some have pointed out that halving the dollar's value against the yen since 1985 has had little effect on trade flows. Treasury's analysis of the dollar-yen relationship and its implications for U.S. firms would be helpful.

Similarly, there has been exchange-rate turmoil in the European Community's Exchange Rate Mechanism (ERM) since last September. This month the Spanish peseta and Portuguese escudo devalued under speculative pressure by 8 percent and 6.5 percent respectively. Substantial devaluations of currencies within the ERM have raised fears of competitive devaluations and the likelihood of their occurring when Europe remains stuck in a period

of low growth. Ultimately, this will call into question the move toward EC monetary union and the impact of the European Monetary Union on U.S. trade flows with the EC.

Finally, the overvaluation of the Mexican peso relative to the dollar and Mexico's widening current-account deficit should be warning signals about the dollar-peso relationship. Should Mexico decide to impose a sharp devaluation or speed the pace of its mini-devaluations, the trade effects of Mexico's reduced tariffs, should NAFTA come into force, could be cancelled. At the very least, we need to consider the benefits of a consultative or coordinating mechanism for exchange rates among the parties of NAFTA.

The Committee also wishes to examine the effectiveness of macroeconomic policy coordination among the G-7 industrialized nations. The 1988 Trade Act requires the President "to confer and negotiate...to achieve better coordination of macroeconomic policies of the major industrialized nations." One of my purposes in authoring this provision was to provide a means for Congress to monitor this important effort. There are those who argue that major surgery is needed if the G-7 process is to become an effective policymaking instrument. I understand the Administration is committed to reinvigorating the G-7 coordination effort and that this is a personal interest of yours, Dr. Summers. The Committee would like to hear your thoughts on this as well as your evaluation of how the recent meetings in February and April may have differed from past gatherings.

All these issues are critical for the way U.S. business--and small business in particular--does its planning and operating. We look forward to hearing from such a distinguished economist as Dr. Larry Summers, and we welcome you to our committee.

STATEMENT OF REPRESENTATIVE JAN MEYERS
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
"CURRENT INTERNATIONAL ECONOMIC CONDITIONS AND THEIR IMPACT ON SMALL BUSINESS"

MAY 26, 1993

Thank you, Mr. Chairman, and thank you, Dr. Summers, for joining us today. While the topic of today's hearing is intellectually interesting, I am not certain that many small businesses would consider exchange rate manipulation a key impediment to exporting.

In addition to my position with this Committee, I am also a member of the Committee on Foreign Affairs and serve on the subcommittee which has jurisdiction over economic policy and trade. Throughout my years on this Committee and on Foreign Affairs, I do not recall having been contacted by an exporter, large or small, who insisted that some other nation's exchange rate policies were a major impediment to exporting. In fact, I had my staff contact a number of small business exporters over the past couple of days and inquire about these concerns. The result was that exchange rate manipulation by our competitors doesn't even appear on the "radar screen" as a concern of small business exporters.

The major impediments to small business export activities are obtaining financing for their exporting efforts, and the regulatory and paperwork burdens both in this country and abroad. Until we address these hurdles facing small business exporters, our inquiries into such areas as G-7 monetary policy and exchange rate movement may be a bit premature in serving a beneficial purpose for this nation's small businesses that are interested in marketing their products and services abroad.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
May 13, 1993

CURRENT INTERNATIONAL ECONOMIC CONDITIONS AND THEIR IMPACT ON SMALL BUSINESSES

Mr. Chairman, I am pleased to have Dr. Summers here this morning to discuss current economic conditions.

I found Dr. Summers' testimony yesterday before the Senate Banking Committee very interesting -- some of his statements were encouraging, others cause me concern.

I share the commitment of the Clinton Administration to free trade and I sincerely hope the President is committed to the successful completion of the Uruguay Round of GATT talks.

Like the President, I am also a strong supporter of NAFTA. In our increasingly global economy, it is essential to continue the strong growth in exports we have enjoyed in recent years. Exports accounted for 70 percent of the growth in our country's GNP over the last three years. In 1991, exports reached a record $422 billion. Clearly, without overseas markets for U.S.-made goods, the recent recession would have been even more devastating to our economy and workers.

In recent years, trade-related jobs have grown three times faster than overall job creation. In my state, there are some 95,000 jobs directly related to foreign trade. Almost 2,000 Minnesota businesses export.

I certainly believe NAFTA, as originally drafted, will promote even greater export growth and economic prosperity for U.S. workers and companies. But I must say I am concerned about certain pending side agreements, which I understand may include some mechanisms that actually restrict trade with Mexico.

I certainly hope the Administration's negotiators recognize that preserving the spirit of NAFTA, as originally drafted, is essential to its success, and that NAFTA is vitally important to the small businesses of our country.

Dr. Summers' comments yesterday about our relations with our trading partners concern me. I certainly applaud the Administration for, as Dr. Summers describes, "changing the atmosphere in meetings [with trading partners], from confrontation to frank discussion, by avoiding public lecturing and recognizing that each country must decide its policies on the basis of its national interests."

But I am concerned that in the same statement Dr. Summers engages in public lecturing himself and prescribes macroeconomic policies for Japan and Europe. "What the world and Japan needs," he said, "is a multi-year commitment to use fiscal policy to achieve domestic demand-led growth and to promote substantial external adjustment."

Dr. Summers continued, "In Europe, interest rates have come down from their peaks. The pace of decline needs to quicken, however, if the current recession is to be brought to an early end. Moreover, structural reforms, particularly in labor markets, are required urgently to produce greater wage and price flexibility."

I am reminded of a comment by a Japanese official in response to advice received during the Clinton Administration's April visit to Tokyo. "Don't you think there are enough problems with America's budget without telling us what's wrong with ours?"

While I certainly realize there are real problems in our trading relationship with Japan, I must say I agree with the Japanese official in this situation -- why is the Administration spending time prescribing economic policies for other nations when our own economy remains stagnant and the budget deficit spirals out of control?

While I agree on the need to improve the balance of trade with our industrial partners, I must say I object to President Clinton's approach to this issue. Instead of focusing on what other countries should do to help our economy, we should be focusing on what we can do for our own economy -- namely, reducing the deficit, lowering taxes and cutting regulations.

The Clinton economic proposal we will consider on the House floor tomorrow will not help our workers and businesses compete with other nations.

Instead, the $328 billion worth of taxes in the Clinton proposal -- the largest tax increase in history -- will stifle domestic production and productivity and destroy jobs.

The energy tax will drive up the cost of domestically produced goods, fuel inflation and erode our competitiveness with our trading partners.

Mr. Chairman and Dr. Summers, economic history shows the Clinton Administration's attempts to revive the economy by raising taxes, increasing the deficit and growing the government will fail. Instead of lecturing our trading partners to repeat our economic mistakes, we should be focusing on removing governmental obstacles to economic growth by cutting taxes and lowering the cost of capital, reducing the deficit, cutting the regulatory burden and opening markets for our goods overseas.

Thanks again for your appearance today and I look forward to this exchange.

THE HONORABLE KWEISI MFUME

OPENING STATEMENT

BEFORE THE COMMITTEE ON SMALL BUSINESS

MAY 26, 1993

MR. LARRY SUMMERS

"DOING BUSINESS IN THE GLOBAL ECONOMY"

GOOD MORNING MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND MR. SUMMERS. I WOULD LIKE TO THANK THE CHAIRMAN FOR HOLDING THIS HEARING AND MR. SUMMERS FOR APPEARING TO SHARE HIS INSIGHT WITH THE COMMITTEE. THIS HEARING IS A RELEVANT HEARING AS NOTHING THAT WE DO TO FOSTER THE GROWTH OF SMALL BUSINESS OCCURS IN A VACUUM. I LOOK FORWARD TO THE TESTIMONY SO THAT WE MAY ALL FURTHER UNDERSTAND THE INTRICACIES OF DOING BUSINESS IN TODAY'S INTERNATIONAL ATMOSPHERE.

WE MUST ALL REALIZE THAT WE LIVE AND DO BUSINESS IN A GLOBAL ECONOMY. EVENTS IN FOREIGN BOARD ROOMS AND GOVERNMENT OFFICES HAVE IMPACTS ON U.S. BUSINESSES AND JOB HOLDERS. IT IS IMPERATIVE THAT LAWMAKERS IN THIS COUNTRY UNDERSTAND THE DYNAMICS OF THE GLOBAL MARKETPLACE SO THAT WE CAN CONTRIBUTE TO THE GROWTH OF BUSINESS IN THIS COUNTRY.

AS WE DELIBERATE ON MEASURES TO STIMULATE OUR ECONOMY WE MUST BE COGNIZANT OF THE EFFECTS OF FOREIGN ECONOMIES ON OUR OWN. WE MUST ENSURE THAT MEASURES WE TAKE DO NOT HAVE ADVERSE EFFECTS ON

OTHER COUNTRIES ECONOMIES. THESE COUNTRIES ARE IMPORTANT MARKETS FOR U.S. GOODS SO A SLOW DOWN "OVER THERE" COULD CONTRIBUTE TO A DOWN TURN HERE IN THE U.S. CONVERSELY, A STRONG GLOBAL ECONOMY SHOULD HELP TO GROW THE U.S. ECONOMY.

I LOOK FORWARD TO HEARING THE INSIGHTS OF OUR DISTINGUISHED GUEST AND I ONCE AGAIN THANK THE CHAIRMAN FOR HOLDING THIS IMPORTANT AND TIMELY HEARING.

DEPARTMENT OF THE TREASURY
WASHINGTON

STATEMENT FOR THE RECORD

STATEMENT OF THE HONORABLE
LAWRENCE SUMMERS
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
May 26, 1993

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today. The Treasury Department's spring 1993 Report on International Economic and Exchange Rate Policy has been presented to the House and Senate Banking Committees, and I am appearing before the Small Business Committee to discuss the report's findings and other issues.

The title of the Report is becoming increasingly outmoded. The distinction between domestic and international economic policy no longer exists, if it ever did. Today, for example, exports and imports each account for roughly 11 percent of national income. In recent years, over half of U.S. income growth and almost all of our growth in manufacturing jobs have been due to growth in exports.

It used to be said that when the U.S. sneezed, the world caught a cold. The opposite is equally true today. Our prosperity is linked inextricably to the maintenance of a strong world economy, open international trading system, and stable global financial markets.

Global Growth

This reality underlies the Clinton Administration's international economic policy. This policy starts from the critical premise that a strong, competitive economy is the most effective international economic policy. We recognize that, while the battle of imports and exports may be fought at the border, domestic policies, in the final analysis, will determine the outcome.

The President has outlined a bold and ambitious program to reduce the budget deficit and revitalize the American economy. The success of this effort will depend importantly on preserving and strengthening an open, growing world economy. It is for this reason that we have placed emphasis on and effort into reinvigorating the G-7 economic policy coordination process.

The President's economic program has brought us new credibility in the international economic arena; it has strengthened our hand in encouraging our major trading partners to take complementary actions to strengthen growth in their own countries. We have also succeeded in changing the atmosphere in the meetings, from confrontation to frank discussion, by avoiding public lecturing and recognizing that each country must decide its policies on the basis of its national interests. But increasingly, where economic growth is concerned, national interests and international imperatives coincide. Finally, we are improving the analytical framework for the surveillance of our economies.

The need for effective cooperation with our G-7 partners has never been clearer than now. We are in the third year of sub-par growth and the prospects for sustained recovery are by no means certain. The United States is experiencing a modest recovery, but with inadequate job creation. Growth in Europe is weak, unemployment high and rising, and recovery still in the distance. Japan is expected to grow only 1.3 percent this year, the lowest rate in nearly 20 years, and its growing external surplus continues to be a drag on the rest of the world.

We have made a beginning and the initial fruits of this effort are being realized. However, we are not out of the woods and more must be done. The prospect of significant U.S. budget deficit reduction and improved saving and investment have been received favorably by the most critical judge, the markets. Long-term interest rates have declined substantially. Some have suggested that the decline reflects a weak economy. However, forecasts for the economy are up, the stock market has increased and credit quality spreads have narrowed. This suggests that the interest rate decline is due to greater confidence in deficit reduction and not a weaker economy. It would be tragic, however, if the nay-sayers succeeded in defeating the President's program, with the end result being both higher interest rates and a weaker economy.

Japan's latest stimulus package is a useful first step but needs to be sustained. The economy is operating well below productive capacity, and consumer and investor confidence is weak. As a result, the trade surplus continues to rise, with new forecasts indicating it could reach over 3 percent of GDP next year.

What the world and Japan needs is a multi-year commitment to use fiscal policy to achieve domestic demand-led growth and to promote substantial external adjustment. The authorities are now in the process of formulating the guidelines for spending in the fiscal 1994 budget. We hope these guidelines will send a message that the April 1993 supplemental stimulus package will be reinforced in next year's budget with continued support for domestic demand.

In Europe, interest rates have come down from their peaks. The pace of decline needs to quicken, however, if the current recession is to be brought to an early end. Moreover, structural reforms, particularly in labor markets, are required urgently to produce greater wage and price flexibility. This would permit economies to adjust more effectively to external developments, without damaging growth, especially given the constraints on exchange rate adjustments.

Negotiations with China, Taiwan and South Korea

A growing world economy and an open international trade and payments system are like two blades of a scissors. You need both to cut to your objective, increased U.S. exports. It is for this reason that President Clinton is committed to a "prompt and successful completion of the [Uruguay] Round" and to implementation of the NAFTA. It also is the basis for our efforts to confront bilaterally the special problems posed by countries with chronic export surpluses, including those that use their exchange and payments systems to impede imports.

In 1992, U.S. exports to China, Taiwan and Korea totalled $37 billion. Exports to Taiwan grew by 15 percent and to China by 19 percent, far exceeding the 6.2 percent growth in total U.S. exports. However, to reach our full potential in these expanding markets, it is essential that their foreign exchange systems be open so that their importers are able to purchase and pay for foreign goods and services.

China

The Chinese economy has grown enormously in recent years and continues to exhibit tremendous potential. Growth last year exceeded 12 percent and in the first quarter this year reached 14 percent on an annual basis. While the economy is now showing signs of overheating, with inflation accelerating, China probably will continue to sustain high real growth over the coming decade. With China increasingly needing high tech imports, the United States has a good chance of sustaining strong growth in exports to China.

That potential for growth appears to be restrained, however, by the opaque and arbitrary foreign exchange system which simply turns away potential importers. Foreign and American joint

ventures in China report that they cannot obtain even the small amount of foreign exchange in the swap centers that they are allocated under government regulations. This shortage of foreign exchange is so severe that Chinese enterprises are beginning to turn once again to the black market. The situation has been exacerbated by companies' hoarding foreign exchange for their own use or for private trading, possibly in offshore financial markets. Hoarding has reduced the supply of foreign exchange to the swap centers and increased pressure for depreciation of the renminbi.

Last year China sustained global trade and current account surpluses, although they declined substantially from 1991 levels. China's bilateral surplus with the United States increased from almost $13 billion in 1991 to over $18 billion in 1992. These outcomes, as well as the pervasive and inflexible restrictions on access to foreign exchange in China, have led Treasury to conclude that China manipulates its foreign exchange system in a manner that prevents effective balance of payments adjustment.

In my recent negotiations with officials from the People's Bank of China, I strongly reiterated the point made by many others in this Administration that China's trade surplus with the United States is a very serious matter that must be addressed by Chinese action now. I stressed that China's foreign exchange controls were acting as trade barriers and were limiting the ability of U.S. firms to export to China. These exchange restrictions will have a bearing on progress made towards China's entry into the GATT.

I also stressed in my talks with Chinese officials that, while China's current account surplus may be on a declining trend in 1992-93, this appeared to be occurring only because China's economy is overheating, with high growth and rising inflation approaching a danger zone. As growth drops to a more sustainable pace, we could expect China's import growth to diminish and the current account to remain in surplus. In that context, a liberalized foreign exchange regime would be necessary to promote the correction of payments imbalances. I also suggested that overall reform of China's foreign exchange system would contribute to a sounder, more evenly paced macroeconomic policy.

These negotiations will continue in the coming months. I believe that the Chinese authorities share our reform goals, although, unfortunately, they will not commit to a specific timetable for implementation of reforms. We will continue to seek action, both in China and other high growth Asian economies, in order to secure access for exports of U.S. goods and services.

Korea and Taiwan

In the past, both Korea and Taiwan were determined to be currency manipulators. While Taiwan was cited as recently as last December, we do not at this time believe that either Korea or Taiwan meets the criteria for that determination.

Korea's global trade and current accounts remain in deficit, albeit substantially reduced from 1991 levels. We have discerned no activity in the foreign exchange market which would signify intervention to influence the exchange rate. However, Korea maintains a system of foreign exchange and capital controls that limit trade and investment flows and thereby dampen the influence of market forces in the foreign exchange market.

In our recent contacts with Korean officials, we have stressed that these controls limit our ability to export to and invest in Korea, and particularly limit the scope of our financial institutions' activities in Korea. We will sustain our efforts to promote market opening.

Taiwan's overall current account remains large but fell significantly from 1991. While the United States remains in bilateral deficit with Taiwan, it does not appear at this time that Taiwan is intervening in the exchange market to limit appreciation of the New Taiwan (NT) dollar. Furthermore, Taiwan's capital controls do not appear to be constraining capital inflows or appreciation of the NT dollar, although the existence of these controls leaves the potential for future interference in exchange rate movements.

Treasury is actively engaged in negotiations with the Taiwan authorities to eliminate the capital controls that can deter potential demand for the NT dollar and to open further its financial services markets to U.S. institutions.

Conclusion

Sound growth in our principal trading partners, coupled with open trade and payments systems, is increasingly essential to the health of the U.S. economy. We have reinvigorated cooperation with other major countries and have begun to see prospects for enhanced growth, but more must be done. U.S. exports to the emerging economic powers of Asia are growing, but not achieving their full potential. At the present time, only China is found to be manipulating its foreign exchange system; however, we remain attentive to the policies of Korea and Taiwan as well.

DEPARTMENT OF THE TREASURY

REPORT TO THE CONGRESS

ON

INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

MAY 1993

Embargoed for release until
10:00 a.m., May 25, 1993

TABLE OF CONTENTS

PART I: SUMMARY AND CONCLUSIONS

This interim report discusses developments in U.S. international economic policy, including exchange rate policy, since the fifth annual report to Congress submitted in December 1992. These reports are required under Section 3005 of the Omnibus Trade and Competitiveness Act of 1988.

While economic recovery is clearly underway in North America, real growth in Japan and Europe is extremely weak. Japan is experiencing its slowest growth in twenty years. Stagnation characterizes most European countries. The U.S. recovery is itself moderate, with limited creation of new jobs. A burgeoning surplus in Japan's current account is threatening to reverse the considerable progress achieved in reducing the external imbalances of the latter part of the 1980s. A positive development in almost all industrial countries is the further ebbing of inflation.

In the face of these developments, the new Administration has sought to reinvigorate the coordination of economic policy among the major industrial countries to strengthen the world economy. In particular, it has sought to create an environment more conducive to frank and informal discussion; suggested ways to improve the analytical framework for considering key issues; and recognized that coordination must take account of national differences and interests rather than seek a common approach. This effort is already producing results. The Finance Ministers and Central Bank Governors of the seven Summit countries (G-7) have agreed that their national objectives of increased growth converge with their international interests and are seeking to implement cooperative policies that reflect their differing economic conditions:

- for the United States and Canada, improved domestic savings and investment, primarily through substantial reductions in fiscal deficits;

- for Europe, measures to stimulate private demand and combat rising unemployment, particularly through further declines in interest rates as a result of implementation of medium-term budget consolidation plans and containment of labor costs and inflation pressures; and

- for Japan, substantial stimulus of domestic demand, which will contribute to reduction of its large external surplus.

Implementation of these policies will lay the basis for sustainable economic growth and reduction of unemployment in the G-7 countries and other market economies. Passage of President Clinton's economic program is the essential U.S. contribution to this agreed approach. In addition, the G-7 are agreed that all must undertake a broad range of structural reforms in order to increase their long-term growth potential, and that a further opening of the international trading system is indispensable for maximizing world growth.

Because of the differing economic conditions and prospects among major countries, the U.S. trade and current account deficits widened somewhat in 1992 and are likely to increase further in 1993. Nevertheless, the U.S. competitive position is strong; the current trend of widening external deficits should slow and eventually reverse course, provided that the G-7 growth strategy outlined above is achieved.

The dollar's value has not changed much in recent months on a trade-weighted basis. However, this overall stability largely reflected offsetting moves against different currencies. A moderate appreciation against European currencies was mainly attributable to the differing prospects for interest rates in Europe and the United States. A decline vs. the yen can be seen as a reflection of forces tending to limit and ultimately reverse Japan's widening trade surplus.

The Administration believes that exchange rates should reflect economic fundamentals and that attempts to artificially influence or manipulate exchange rates are inappropriate. At the same time, excessive volatility of exchange rates is counterproductive for growth. Consequently, the United States remains ready to cooperate in exchange markets with its G-7 partners.

Exchange rate policies of emerging trading powers such as China, Korea and Taiwan continued to receive the close attention of U.S. authorities. These countries have at various times in the past been deemed to be "manipulating" the exchange rate of their currencies vs. the dollar in the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988. The Treasury Department has held a combination of formal and informal talks with the authorities of these countries aimed at encouraging the removal of measures which do or might discourage appreciation of their currencies in response to market forces.

In this report, Treasury has concluded that China manipulates its foreign exchange system. China's global trade and current accounts remained in surplus in 1992, although these surpluses have declined somewhat, and its foreign reserves have increased further. Its bilateral surplus with the United States widened. Despite these factors, China continues to maintain significant limits on foreign exchange activity which impede balance of payments adjustments by restricting imports.

It is Treasury's judgement that Taiwan is no longer manipulating its currency. A significant element in the analysis underlying this conclusion is that Taiwan's global current account and trade surpluses narrowed significantly in 1992, and its bilateral surplus with the United States declined. However, the Department remains seriously concerned that significant restrictions on foreign exchange trading and international capital transactions remain and may be reducing demand for the NT dollar. Although the depreciation of that currency in recent months was not the consequence of official actions that could be deemed a manipulation, Treasury notes that the instruments needed for manipulation are still in place.

As in the December 1992 Report, the Treasury Department does not find that South Korea has been manipulating the exchange rate of the won. South Korea continues to register deficits in its trade and current accounts, although they narrowed sharply in 1992. Korea's bilateral trade balance with the United States registered a surplus and foreign reserves increased to the highest level ever recorded. However, the authorities do not appear to be intervening in the exchange market to prevent an appreciation of the won.

PART II: GLOBAL ECONOMIC DEVELOPMENTS, IMPACT ON U.S. BALANCE OF PAYMENTS, AND THE G-7 RESPONSE

A. ECONOMIC SITUATION IN THE G-7 COUNTRIES

Growth

Real GDP growth in the G-7 countries in 1993 now shows a clear distinction between an expanding North America and a Europe and Japan in recession/stagnation. The **U.S.** recovery appears clearly on track -- although growth remains unusually moderate for a recovery period -- while **Canada** also is on an expansionary path. The International Monetary Fund (IMF) now projects (see Table 1 below) U.S. real GDP growth of 3.2% on a year-over-year basis for both 1993 and 1994, while Canada is expected to grow at a 3.2% rate this year and 4.4% in 1994.

Table 1
G-7 Real GDP Growth
(% change y/y)

	1992	1993F	1994F
United States	2.1%	3.2%	3.2%
Japan	1.3	1.3	3.5
Germany*	2.0	-1.3	1.7
France	1.4	0.0	2.3
United Kingdom	-0.6	1.4	3.1
Italy	0.9	0.3	1.9
Canada	0.9	3.2	4.4
Total G-7	1.6	1.9	3.0

* All Germany; comparable figures for GDP growth in western Germany only are 1.5%, -2.0% and 1.2%. F = forecast; source: IMF, World Economic Outlook, April 1993

Growth in **Japan** has decelerated sharply; last year's performance was the lowest in nearly 20 years. Exports were strong, however, as Japan's markets in Asia experienced solid growth and recovery in North America continued. The stock market and land price declines have made both borrowers and lenders more cautious, and the earlier boom in private investment led to a build-up of plant and equipment that may now seem excessive to business decision makers. Thus consumption and private investment spending are likely to remain subdued for some time. The Japanese authorities have announced a substantial fiscal expansion package, to be put into effect this year. While this package is a welcome first step, a sustained effort is needed to put Japan back on its potential growth path and to reduce

its large external surpluses. The IMF staff's projection of 1.3% real GDP growth for Japan this year includes the estimated impact of the fiscal program in the current calendar year. Thus it appears that the fiscal package has served more to prevent a recession or near recession than to guarantee a strong expansion. With this in mind, the Fund's projection that Japanese growth will snap back to 3.5% in 1994 without further policy action could be optimistic.

The outlook for Europe is very disappointing. Of the four largest countries, only the United Kingdom is expected to show measurable positive growth in 1993, and the low forecast of only 1.4% growth for this year follows two recession years. The decline in German interest rates since last summer's peaks is an encouraging sign, but the cautious nature of the Bundesbank's action, together with the normal lags in the impact of monetary policy, will likely mean that recovery in Europe is delayed until 1994. For the EC as a whole, the IMF sees essentially no growth (+0.1%) this year and only 2.2% for 1994.

Inflation

Inflation has been declining in most G-7 countries, and low inflation for the G-7 as a group is likely to continue. IMF projections for consumer price increases (see Table 2 below) show inflation at the lowest aggregate rates (excepting the 1986-88 period when world petroleum prices fell sharply) since the early 1960s.

Table 2
G-7 Consumer Price Inflation
(% change y/y)

	1992	1993F	1994F
United States	3.0%	3.0%	3.1%
Japan	1.6	1.0	1.5
Germany*	4.5	4.4	2.5
France	2.3	2.0	2.5
United Kingdom	3.8	2.1	4.0
Italy	5.4	5.7	5.2
Canada	1.5	2.3	2.0
Total G-7	3.0	2.8	2.9

* All Germany; comparable figures for western Germany only are 4.0%, 3.8% and 2.1%.
F= forecast; source: IMF, World Economic Outlook, April 1993

While Italy continues to have the highest inflation rate among the G-7 (although the rate is now declining), inflation in Germany has been of major concern, in part because high interest rates in Germany to contain inflation have spread to other European countries and impeded economic recovery. However, Germany's inflation outlook is slowly improving. Consumer price inflation has been raised temporarily by the one percentage point rise in

value added tax on January 1, which added about half a point to the year-over-year rate for western Germany (4.2% in March 1993). Significantly lower wage settlements this year -- in the 3 to 3-1/2% range, vs. 5-1/2 to 6% last spring -- should contribute to a lower inflation picture which should be visible in coming months. Slower monetary growth is also now evident.

External Account Developments

The most important development in the external accounts of the G-7 countries has been **Japan's** record high and rising trade and current account surpluses. IMF projections for the G-7 are shown in Table 3.

Table 3
G-7 Current Account Balances
($ billions (% GDP))

	1992		1993F		1994F	
United States	-$62.4	(-1.0)	-$101	(-1.6)	-$131	(-2.0)
Japan	+117.6	(3.2)	+137	(3.4)	+128	(3.0)
Germany*	-25.9	(-1.3)	-27	(-1.4)	-24	(-1.2)
France	+ 2.5	(0.2)	+2	(0.2)	+3	(0.3)
United Kingdom	-21.1	(-2.0)	-26	(-2.8)	-26	(-2.7)
Italy	-25.2	(-2.1)	-16	(-1.6)	-14	(-1.3)
Canada	-23.6	(-4.2)	-19	(3.3)	-15	(-2.4)
Total G-7	-38.1	(-0.2)	-49	(-0.3)	-79	(-0.5)

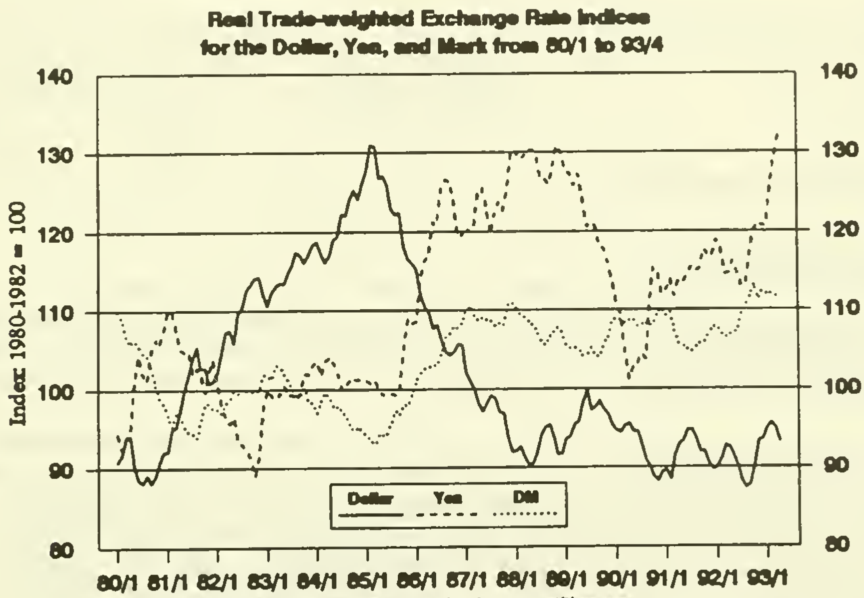
* All Germany
F= forecast; source: IMF, World Economic Outlook, April 1993

The IMF's forecast of a modest decline in the Japanese surplus next year is open to doubt. (In the preceding two years, the Fund tended to underestimate the surplus significantly.) With projected stronger growth in Europe and Canada, and continued solid growth in the United States (3.2%) and in Asian developing countries (6-1/2%), Japanese exports should continue to grow. (Using Bank of Japan price deflators to derive indices of Japanese export and import volumes indicates that the volume of Japanese exports grew 8.0% in 1991 and 5.3% in 1992, while the volume of imports grew only 2.6% in 1991 and actually fell 1.4% in 1992.) Imports are likely to remain weak as the Japanese economy grows below trend performance. The yen's rise earlier this year, if sustained, would eventually provide some counterweight to the forces tending to increase Japan's surpluses. On balance, however, it is still possible that Japan's surpluses could increase rather than decrease next year.

The Fund also may have overestimated U.S. current account deficits for 1993 and 1994. While the U.S. deficit is expected to rise to over $100 billion by 1994 (see the section on the U.S. balance of payments), the moderate nature of the U.S. expansion and the strong competitive position of U.S. exports (of both goods and services) should help restrain the rise in the trade and current account deficits of the United States.

On the latter point, Chart 1 shows the value of the dollar (and yen and DM) in relation to the currencies of a number of major trading partners, adjusted for differences in national inflation rates. These real trade-weighted exchange rates for the three most important world currencies are at least a rough measure of national trade price competitiveness. The chart shows that the dollar has maintained the competitive position it regained by early 1988, with only moderate fluctuations since that time on a real trade-weighted basis. The yen, on the other hand, has risen to levels which are now the highest in the period shown (January 1980 - April 1993). The DM has shown less dramatic changes. Exchange rate movements for the period since early October 1992 are described in greater detail below.

Chart 1



Note: A rise in the index = appreciation/decline in competitiveness;
a fall in the index = depreciation/increase in competitiveness.

*Source: JP Morgan; 1980 trade weights (18 industrial and 22 developing countries; 1980 - 82 = 100. Data are thru April 30, 1993).

B. DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS

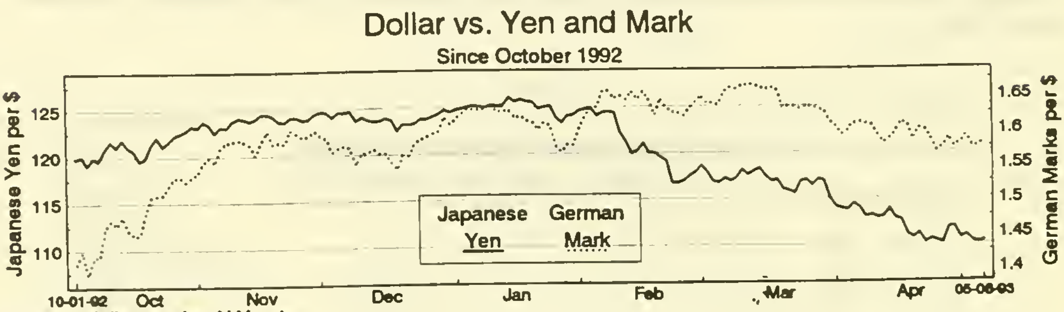
Overview

Since early October 1992, the dollar has declined by approximately 8% vs. the Japanese yen and has appreciated by approximately 11% vs. the German mark. On a trade-weighted basis, the dollar rose by 0.1%.

The main factor affecting dollar movements against European currencies was the difference in cyclical conditions in the United States and Europe. The dollar firmed amid a recovery in the U.S. economy and a downturn in Europe, which contributed to expectations in the market that interest rate differentials unfavorable to dollar placements would narrow. Meanwhile, Japan's economic slowdown weighed on the yen, although the effect on the yen/dollar exchange rate was mitigated by uncertainty about the U.S. presidential election and, later, about the policy direction of the new Administration.

Subsequently, cyclical disparities between the United States and Japan were overshadowed by market perceptions that the G-7 countries, and perhaps the United States in particular, would favor appreciation of the yen as a means of addressing Japan's trade surplus. Also, there was a broader concern in the market that the United States might welcome a decline of the dollar against other currencies as well.

Chart 2



Source: daily opening N.Y. rates

Differing Economic Cycles

The pace of the U.S. economy in the fourth quarter of 1992 led market participants to believe that prospects for further monetary easing by the Federal Reserve had all but ended. Expectations of fiscal stimulus measures under the new Administration were also a factor.

Meanwhile, deteriorating economic conditions in Europe encouraged expectations that interest rates there would trend lower. Some European central banks began lowering interest rates in the weeks following the September currency crisis in the European Monetary System. The Bundesbank lowered its official rates in February, but the market remained unconvinced that a monetary easing cycle had definitively begun in Germany. Subsequently, it became apparent that further easing by the Bundesbank would proceed very gradually.

Moreover, the market was disappointed with "soft" U.S. economic growth in the first quarter and early second quarter of 1993. Consequently, there was little incentive to take on

long dollar positions, particularly amid only a gradual narrowing of interest rate differentials unfavorable to dollar placements. Declines in German money rates and, in April, a further official interest reduction by the Bundesbank did not materially change this situation.

The market also viewed Japan's economic adjustment, particularly the decline in domestic demand and the involuntary accumulation of inventories, with mounting concern. The political situation in Japan compounded the market's caution toward yen assets. However, the market saw that, relative to Europe, Japan had little scope for further reducing its already low interest rates and better prospects for economic recovery. Although confined to a narrow range against the dollar, the yen appreciated in terms of European currencies.

There were signs in the first quarter of 1993 that the Japanese economy was nearing a cyclical bottom and would soon be poised to begin a recovery. The Bank of Japan's action to lower interest rates in early February was welcomed in the market and contributed to the emergence of more positive market sentiment toward yen assets amid a rebound in the Japanese stock market and expectations of a fiscal stimulus to support economic recovery.

Market Perceptions of Official Policies

Amid signs of slow growth in the United States and a steeper than expected decline in Continental European economies, the yen appreciated to a record level of ¥ 109.25 in April. A key factor in this appreciation was the belief in the market that the G-7 countries viewed a higher yen as a means of addressing Japan's widening trade surplus.

The yen's appreciation was particularly sharp during February, when many market participants expected the G-7 to make a pronouncement specifically in favor of a higher yen. However, the February G-7 meeting did not result in such a call. Ahead of another G-7 meeting in April, Japanese officials expressed concern about prospects for further yen appreciation, and there were reports of Japanese intervention to curb the yen's rise. The U.S. authorities were also reported to have intervened at one point. The April meeting also produced no specific references to the yen, and exchange rates have remained relatively steady since.

The clarification of U.S. policies on exchange rates was designed to keep the market's focus on the real issues of the economic policies that are needed among G-7 countries to support sustainable, non-inflationary economic growth. As stated in the communique of the April G-7 meeting, a cooperative strategy for non-inflationary growth, based on sound policies, structural reforms, and more open trade, will foster conditions in currency markets that will reflect economic fundamentals. The major challenge that the G-7 faces is to restore growth and to ensure that the composition of growth contributes to the reduction of trade imbalances.

C. U.S. BALANCE OF PAYMENTS SITUATION

The U.S. trade and current account deficits rose in 1992, after declining for four consecutive years. This reversal was not unexpected, since the U.S. economy was in a recovery mode while major trading partners were heading into recession. Thus, the deterioration in the U.S. external position is not seen as symptomatic of a decline in U.S. competitiveness, but rather as the result of cyclical factors.

The trade deficit rose to $96 billion in 1992, compared with $73 billion for 1991. Reflecting the cyclical situation, U.S. exports slowed while imports grew over 9% after a very slight decline in 1991. U.S. export performance was characterized by a slight fall in exports to Europe and Japan in value terms, but increases to all other major geographic areas. Exports to Latin America, especially Mexico, rose sharply. Overall, export growth was substantially below rates of recent years, when the trade deficit was declining. Imports picked-up from near stagnation in 1991. The pick-up was primarily in finished manufactures, notably capital and consumer goods. Reflecting the impetus from stronger U.S. growth, increases in imports were spread across geographic areas and supplier countries.

On a regional basis, the largest contributors to the total trade balance deterioration of $23 billion were W. Europe (-$12 billion), Japan (-$6 billion), and China (-$5.5 billion).

Table 4
U.S. Trade with Selected Areas: 1991&92
($ billion; data from Survey of Current Business)

Country	Exports to		Imports from		Balance	
or Region	1991	1992	1991	1992	1991	1992
W. Europe	116.8	114.4	101.9	111.4	+14.9	+3.0
Japan	47.2	46.9	91.5	96.9	-44.3	-50.0
China	6.3	7.5	19.0	25.7	-12.7	-18.2
Asian NIEs	44.4	46.9	59.2	62.4	-14.8	-15.5
L. America	63.2	75.3	63.0	69.2	0.3	+6.2
R. O. W.	138.1	148.3	154.8	169.9	-16.8	-21.8
TOTAL	416.0	439.3	489.4	535.5	-73.4	-96.3

By contrast with the merchandise trade balance, the balance on trade in services recorded a substantial surplus ($55 billion) in 1992, $10 billion higher than the 1991 surplus. Trade in a wide range of services has emerged as a major area of U.S. competitive advantage, recording steadily rising surpluses in recent years.

Net investment income also reflected the relative cyclical position. Receipts on U.S. direct investments abroad, weakened by the recession in Europe, fell while the reviving U.S. economy produced a shift from losses to modest gains on foreign direct investments in this country. The overall surplus on net investment income fell to $10 billion, a $6 billion decline which partially offset the gain on services transactions.

Given the relatively modest size of balances in other categories of transactions, the current account balance has tended to move with the trade balance over time. For 1992, the current account deficit rose -- after adjustment to remove the one-time influence of foreign transfers in support of Desert Storm -- by $16 billion, compared with $23 billion for the trade deficit.

Table 5
U.S. Trade and Current Account: 1987; 1991-2
($ billion: data from Survey of Current Business)

Balance	1987	1991	1992
Trade	-160	-73	-96
Services	8	45	55
Investment Income	11	16	10
Transfers	-23	-34*	-31
Current Account	-163	-46*	-62

*Adjusted to exclude $42 billion in transfers from allies in support of Desert Storm.

Recorded net capital inflows totalled $75.6 billion, of which $24.3 billion was accounted for by private flows while the remainder reflected official transactions. (The difference between the current account deficit and the recorded capital flow is categorized as the "statistical discrepancy".) By contrast with the large inflows of recent years, there was a small outflow from the United States by foreign direct investors in 1992, which combined with continued investment activity abroad by U.S. direct investors to generate a net direct investment outflow of $39 billion. Foreign purchases of U.S. securities rose by $14 billion, while there was a substantial net inflow ($47 billion) through banking channels.

Prospects for 1993 and 1994

The relative growth performance of the United States and major trading partners is expected to dominate the trade and current account outlook for 1993 and into 1994.

o Based on present prospects for U.S. and foreign growth, it seems likely that the U.S. trade and current account deficits will increase this year and next, with an expanding trade deficit overwhelming a further increase in the net surplus on trade in services.

o The trade deficit probably will rise to well over $100 billion this year, and the current account deficit may well reach or exceed $100 billion in 1994.

A sustained upward trend in the deficits could be of particular concern if the gap became so large that very rapid export growth was required just to keep the gap from widening further. (For example, when the trade deficit was at its peak in 1987, exports were only about 60% as large as imports. This meant that exports had to grow nearly 1-1/2 times as fast as imports just to avoid further increases in the deficit. At present, exports total over 80% of imports.)

There are important differences between the present situation and the episode of rising deficits during the mid-1980s, however.

o The U.S. competitive position is strong in merchandise trade as well as the growing services industries. Exports are sluggish because some overseas markets are not growing.

o U.S. national saving should increase, rather than deteriorate as was the case during the 1980s, particularly with adoption of the President's economic program.

o Important sources of surging imports during the first half of the 1980s are no longer present.

-- An increasing share of U.S. sales by Japanese auto firms is now sourced in the United States. Thus, imports of Japanese autos have declined as a percent of Japanese market share. Moreover, total Japanese market share has declined, reflecting the more competitive position of U.S. auto makers.

-- Exchange rate changes have reduced the strong competitive advantage previously enjoyed by the Asian NIEs.

D. NEW G-7 COOPERATIVE APPROACH TO GROWTH

Two major, interrelated international economic challenges presented themselves to the new Administration upon taking office: 1) reinvigorating the G-7 process in order to 2) help strengthen the global economic recovery. The need for concerted G-7 action was made clear by the moderate nature of the U.S. recovery, continued sub-par prospects in the other major countries, and growing external imbalances. At the same time, there were concerns over the G-7's inability in recent years to agree to a common approach to promoting growth due to cyclical divergences in performance among countries and differences in economic priorities.

Revitalizing the G-7 is a high priority of the Administration because of the increasingly significant impact of global trade and capital flows on U.S. economic prospects.

Rising net exports of goods and services accounted for 40 percent of U.S. growth between 1987 and 1991 and contributed importantly to new, comparatively high-paying jobs. Thus, the slowdown in overseas markets in 1992 and continued weak prospects in 1993 are of particular concern. In addition, the recent Group of Ten (G-10) study on International Capital Movements and Foreign Exchange Markets underscores the importance of efforts by the major industrial countries to implement compatible policies in order to ensure efficient and stable financial markets.

Against the backdrop of continued economic uncertainty, the United States took the lead beginning earlier this year in coordinating a new cooperative G-7 approach which would 1) ensure a strong recovery that created jobs and 2) establish the basis for sustainable growth over the medium term. Rapid and tangible progress has been made over the past few months.

At an informal G-7 Ministerial meeting in London on February 27, Secretary Bentsen presented the President's economic program to his G-7 colleagues. The new program was well-received as both a serious contribution to world growth and a tangible reflection of the U.S. commitment to enhanced G-7 coordination. By making politically difficult choices on a comprehensive deficit reduction plan -- something our allies have recommended for some time now -- the United States gained valuable credibility which enhanced the possibility of eliciting complementary policy actions by others, particularly Japan and Germany.

The new U.S. approach reflects changes in tone as well as substance in fostering a new cooperative G-7 approach to growth. As noted earlier, the U.S. has sought to foster a more results-oriented process that encourages more frank and informal discussions. To enhance the quality of G-7 surveillance over economic developments, a common analytical framework is being developed to improve the comparability of economic data across countries. To facilitate actions toward mutually desired goals, this new approach recognizes the need to take into account national differences and interests, rather than seeking a common approach, which too often proves elusive and which may not be appropriate given the unique circumstances in each country.

Recent actions by the United States, Germany, and Japan reflect the convergence of national objectives and international interests:

1) The President's economic program offers a blueprint for sustainable growth this year and into the future. The new package's inclusion of substantial deficit reduction measures totaling $500 billion over five years and measures to increase public and private investment are critical to improving U.S. competitiveness and growth prospects.

2) The 13 trillion yen ($119 billion) Japanese fiscal stimulus package represents a positive step toward boosting domestic demand and reducing the growing trade surplus. Further actions may be warranted, however. Most analysts estimate that only about half of this package clearly represents a direct addition to domestic

demand. As noted earlier, the IMF forecasts only 1.3% Japanese growth this year after accounting for the stimulus package. The Japanese economy is operating below its potential, and a sustained fiscal stimulus is the most effective means for increasing growth in a timely fashion. Japan's strong fiscal and net public debt positions provide ample room for further action in this regard.

3) The pace of reductions in German interest rates may be quickening. Just prior to the recent G-7 Ministerial, monetary authorities cut the Lombard rate by 1/2 a percentage point to 8.5% (reducing short-term interest rates to levels some 220 basis points below September 1992 rates). Recent Bundesbank actions and comments appear to reflect the view that the balance of risks in the German economy have swung from inflation to stagnation. Accelerated action to reduce interest rates appears warranted. The Solidarity Pact among German labor, business, and federal and state governments should help contain wage increases and reduce government borrowing over the medium-term, enhancing the scope for a further easing of interest rates.

Recent Japanese and German measures to increase growth represent significant complements to the President's economic program that should result over time in increased U.S. exports and jobs as economic growth picks up in Europe and Japan. At the same time, the United States has made clear that more actions may be warranted to ensure a strong recovery. For its part, the United States must implement the President's program in order to maintain the momentum of current policy directions, including further complementary policy measures in Japan and Germany. G-7 countries will continue to monitor the impact of these actions and have reaffirmed their continued commitment to close cooperation in exchange markets.

PART III: NEWLY INDUSTRIALIZED ASIAN ECONOMIES AND CHINA

Under Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, the Secretary is required, on an annual basis, to "consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations...on an expedited basis...for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate unfair advantage."

In the first report (fall 1988), Treasury determined that Taiwan and Korea manipulated their currencies within the meaning of the legislation. Following bilateral negotiations, Treasury concluded that, while significant problems remained, Taiwan (as of the fall 1989 report) and Korea (as of the spring 1990 report) were no longer manipulating their currencies. These findings were reaffirmed in fall 1990, spring 1991, and fall 1991. The applicability of Section 3004 to China was first considered in fall of 1990; in that report and in the spring and fall 1991 reports, Treasury noted that China's exchange rate controls were of serious concern but did not find that currency manipulation was occurring.

In the spring and fall 1992 reports, Treasury reaffirmed its determination that Korea was not manipulating its currency. However, with regard to Taiwan, Treasury determined that Taiwan was once again manipulating its currency, as it was using central bank intervention and restrictions on foreign exchange transactions and capital flows to constrain demand for the NT dollar, even though its external surpluses were increasing.

With respect to China, Treasury found that China was also manipulating its currency. The basis for the changed judgement was the continued devaluation of the administered exchange rate, despite growing external surpluses, and the significant control exercised by the authorities over foreign exchange swap center rates which had also depreciated since the emergence of the large surpluses.

As a result of these manipulation findings, Treasury initiated negotiations with China and Taiwan during 1992. The remainder of this chapter describes the results of those negotiations, as well as recent balance of payments and exchange rate developments, and assesses the foreign exchange systems of China, Taiwan, and Korea.

TAIWAN

Taiwan continues to have a material global current account surplus and a significant bilateral trade surplus with the United States. However, it is the judgement of the Treasury Department that Taiwan is not at this time manipulating the rate of exchange between the New Taiwan (NT) dollar and the U.S. dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade.

Notwithstanding this determination, and particularly in view of the fact that Taiwan continues to have large external imbalances (including a $9.4 billion trade surplus with the United States in 1992), the Treasury Department remains seriously concerned that restrictions maintained by Taiwan on foreign exchange transactions and capital flows continue to reduce market demand for the NT dollar and thereby amount, in effect, to indirect manipulation of the exchange rate.

Despite several rounds of negotiations during 1992, Taiwan appears unwilling to remove the restrictions that can constrain demand for the NT dollar and unwilling to guarantee that it will not again engage in practices that constitute direct manipulation of the exchange rate. Permitting the full range of market forces to determine the level of demand for the NT dollar would likely contribute to further adjustment of the existing bilateral trade imbalance.

Trade and Economic Developments

Significant adjustment seems to be taking place in Taiwan's overall external imbalances. The current account surplus fell 34 percent to $7.9 billion in 1992 (3.8 percent of GDP) from $12.0 billion in 1991 (6.8 percent of GDP). This decline was attributable both to a smaller overall merchandise trade surplus, which fell to $9.5 billion from $13.3 billion in 1991 (a decline of 29 percent) and to a larger deficit in services and income, which rose to $4.7 billion in 1992 compared to $3.5 billion in 1991.

However, recent adjustment in Taiwan's bilateral trade surplus with the United States has been rather modest. The 1992 surplus of $9.4 billion represents only a slight decline from $9.8 billion in 1991, less than half the adjustment that occurred in 1991. Data for the first three months of 1993 show a continued decline in the imbalance. U.S. exports to Taiwan grew 15.3 percent in 1992 compared to 1991, substantially faster than the 6.3 percent growth in overall U.S. exports.

Taiwan ended 1992 with $82.3 billion in foreign exchange reserves, equal to roughly 14 months of imports, and, after Germany, had the world's second largest holdings. By comparison, the industrial countries, on average, hold non-gold reserves equivalent to 2-3 months of import cover.

Exchange Rate Developments

Market pressures have resulted in a depreciation of the NT dollar since the December 1992 report, which is likely to impede further reduction of the bilateral imbalance. The exchange rate stood at NT$ 25.96 per U.S. dollar on May 19. The NT dollar has depreciated 2.2 percent since end-1992, and 5.7 percent since it reached a record high in July 1992. The NT$ appreciated a scant 1.3 percent during 1992. The recent decline of the NT dollar and consequent increase in Taiwan's global competitiveness would have been even greater if exchange rate changes against non-dollar currencies and inflation differentials are taken into account.

The NT dollar has declined even more markedly against the Japanese yen -- 13 percent since end-1992 alone. As Taiwan purchases most of its imports from Japan (30 percent in 1992) and the United States (21 percent in 1992); a depreciation of this magnitude will raise import prices and increase inflationary pressures in Taiwan's domestic economy.

Exchange Rate System

Taiwan retains a variety of controls and restrictions that provide scope for currency manipulation. Collectively, these controls help to limit the volume of trading in Taiwan's foreign exchange market, which remains small and thin. As a consequence, the central bank can still exert strong influence in the foreign exchange market. The key controls described below were covered more fully in the fall 1992 report; no significant changes have occurred since that report.

The lack of transparency in activities of the central bank means that it continues to retains the ability to intervene directly in the exchange market, use proxies to intervene indirectly, or manage purchases by state-owned corporations.

Ceilings on foreign exchange liabilities, which vary from bank to bank, still affect forward trading in the NT dollar. The ceilings also constrain the ability of foreign bank branches, including branches of U.S. banks, to offer foreign currency loans in Taiwan and to use swap funding for local currency lending. In place of the quantitative limits imposed by these ceilings, prudential concerns in this area could be addressed through other means, such as through risk-based capital requirements that apply to the financial institution as a whole.

The scope of the forward foreign exchange market is restricted by a number of rules that prohibit transactions for non-trade-related purposes, limit trading to authorized banks, impose a sizeable deposit guarantee, and limit the maximum forward period to one year. These restrictions also prevent foreign banks and securities firms both in and outside of Taiwan from hedging capital in Taiwan's onshore market.

Non-trade-related capital inflows and outflows are limited to $5 million per firm or individual (capital flows for trade purposes are unlimited). The amount of cash an individual may carry in and out of Taiwan is limited to NT$40,000 (about $1,500).

The ability of foreign institutional investors to invest in Taiwan (i.e., in NT dollar-denominated financial instruments) is constrained by government regulation, in part due to fears that such investment will increase the demand for NT dollars. Restrictions include a cap on the aggregate amount of foreign investment in the stock market, limits on the amount of capital that can be brought in by any one investor, and a minimum time that must elapse before capital and earnings can be repatriated. Investment by foreign individuals is prohibited altogether. Efforts by Taiwan to improve the attractiveness of its financial markets could increase foreign interest and promote capital inflows that could lead to increased demand for the NT dollar.

Exchange Rate Negotiations

After determining that Taiwan was manipulating its currency under Section 3004, Treasury held four meetings with the Taiwan authorities during the course of 1992. Despite these negotiations, Taiwan has not made any significant changes in the array of controls and practices that provide the authorities with sufficient scope to manipulate or strongly influence the exchange rate. During the last round of negotiations, the central bank promised publicly to review its controls with the intention of removing those that are unnecessary, a commitment that it has not fulfilled. No significant action has subsequently been taken, though Taiwan has taken several very modest steps to remove impediments to appreciation of the NT dollar.[1] The Taiwan authorities appear to hope that, by retaining a capability to manipulate or strongly influence the exchange rate, they will be able to slow or avoid the gradual internationalization of the NT dollar that should accompany the island's growing economic stature as a global trader and investor.

Assessment

The present determination represents a change from Treasury's assessments of May and December 1992 that, in the context of Taiwan's large and increasing external imbalances, the system of exchange and capital controls maintained by the central bank, as well as its direct and indirect involvement in the exchange market, constituted manipulation of the currency.

Three developments described above have led to our changed determination. First, the array of controls on capital inflows and exchange transactions maintained by the central bank do not appear at this time to be directly constraining appreciation of the NT dollar. Second, it does not appear that the central bank has been intervening in the exchange market to dampen pressures for appreciation. Instead, on a number of occasions during the past

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[1] The foreign exchange liabilities ceiling for all commercial banks was raised in two stages from $19.2 billion to $20.6 billion. Also, the ceiling on investment by a foreign institutional investor was effectively raised from $50 million to $100 million (after the first $50 million is brought in, an institutional investor can apply to bring in another $50 million).

several months it appears to have intervened in the market to support the NT dollar. Finally, significant adjustment seems to be taking place in Taiwan's overall current account surplus.

With regard to the outlook for further reduction in Taiwan's trade imbalance with the United States, the imbalance may grow without NT dollar appreciation in the months ahead. In view of the lack of appreciation in the NT dollar during 1992, Taiwan's exporters may become even more competitive in world markets, particularly in the U.S. market as our own economy grows more rapidly than Taiwan's other export markets.

Consequently, Treasury remains concerned that, if strong market pressures for NT dollar appreciation recur in the period ahead, Taiwan might again resort to currency manipulation, using instruments at its disposal, in order to limit the rise of the NT dollar. Taiwan expects that its economy will continue to grow strongly. Taiwan has targeted GNP growth of 7 percent in 1993, up from 6.1 percent in 1992. Interest-rate differentials between NT dollar- and U.S. dollar-denominated assets appear to be increasing as monetary policy tightens in response to re-emerging inflationary pressures. Confidence in Taiwan's stock market seems to be growing, which has fueled foreign interest and spurred capital inflows from foreign institutional investors. Political uncertainty has diminished with the election of a new Legislative Yuan in December 1992 and the appointment of a new premier and cabinet in February 1993.

Because of the serious nature of these concerns, Treasury will continue to monitor Taiwan's exchange rate policies closely in the period leading up to the next report to Congress to determine whether the authorities are again manipulating the exchange rate of Taiwan's currency and to ensure that the exchange rate is playing an appropriate role in adjustment of Taiwan's external imbalances, including its bilateral trade surplus with the United States.

In this regard, Treasury would view official actions or practices that interfere with the role of market forces in exchange rate determination -- such as intervention in the foreign exchange market to dampen pressures for appreciation or maintenance of restrictions on foreign exchange transactions or capital inflows that appear to constrain NT dollar appreciation -- as an effort by the authorities to manipulate the exchange rate to inhibit effective balance of payments adjustment and gain unfair competitive advantage in international trade.

Furthermore, Treasury will use further discussions to seek changes in Taiwan's exchange rate policies and restrictions on capital movements with respect to both their impact on external adjustment, and their harmful effect on U.S. financial firms in Taiwan. Finally, with regard to Taiwan's accession to the GATT and the economic and political benefits GATT membership will bring, the United States has noted that, under the GATT Articles, Taiwan must negotiate a special exchange arrangement with GATT members to ensure that Taiwan cannot use exchange rate policies to frustrate the intent of GATT trade provisions.

SOUTH KOREA

The Treasury Department does not find the Korean authorities to be manipulating the exchange rate directly to gain unfair competitive advantage in international trade or to prevent effective balance of payments adjustments. Korea's external deficits were reduced significantly in 1992 as economic growth slowed following the implementation of stabilization policies in late 1991 and throughout 1992. There continues to be little evidence that the Korean central bank is intervening in the exchange market, and the level of activity of other government-owned foreign exchange banks in the market has been minimal since the fall 1992 report. Treasury remains concerned, however, about the continued prevalence of stringent foreign exchange and capital controls that thwart the influence of market forces in the determination of Korea's exchange rate and trade and investment flows. Such controls frustrate the emergence of a truly market-determined exchange rate.

Recent Developments

The Korean economy in 1992 experienced the consolidation of a process of adjustment after the 1990-91 period of overheated growth. Real GNP growth slowed to 4.7 percent, compared to 8.4 percent in 1991 and 9.4 percent in 1990. At the same time, substantial progress was made in addressing the effects of two years of excessive domestic demand caused in part by expansive financial policies initiated in 1989. Consumer price inflation in 1992, at 4.5 percent (down from 9.3 percent in 1991), was the lowest in six years.

In 1992, the current account deficit was cut nearly in half to $4.6 billion (1.6 percent of GNP) from $8.7 billion in 1991 (3.1 percent of GNP). Stabilization policies to cool domestic demand and the overheated construction sector resulted in import growth of just under 1 percent, compared to 17.7 percent a year earlier. Although export growth declined from 10.3 percent in 1991 to 7.9 percent in 1992, exports grew faster than imports for the first time since 1988. The overall trade deficit fell in 1992 to $2.2 billion from $7 billion in 1991.

According to the U.S. Department of Commerce, the United States recorded a bilateral trade deficit with Korea of $2.1 billion in 1992, compared to $1.5 billion in 1991. Korean data show a slight surplus for the United States in 1992, and indicate that Korea also had deficits with Japan, the EC, and China, but surpluses with countries in Southeast Asia and Latin America.

In the capital account, overall net capital inflows totalled $7.8 billion in 1992, up from $4.2 billion a year earlier. The increase is largely the result of a rise in long-term capital inflows following the limited opening of the Korean stock market to foreign investment in January 1992. The level of Korea's net foreign debt declined by 8.2 percent from $11.9 billion in 1991 to $11 billion in 1992 (3.7 percent of GNP). Korea's debt service ratio is estimated to have remained stable in 1992 at 6 percent.

Korea's foreign exchange reserves maintained an upward trend in 1992 in conjunction with the continued improvement in the external accounts, rising $3.4 billion to $17.1 billion (2.7 months of import coverage), the highest level ever recorded.

As of May 19, 1993, the exchange rate stood at 801.1 won per dollar, representing a nominal depreciation of 1.2 percent since the end of 1992. Since the inception of the market average rate (MAR) system on March 2, 1990 (see fall 1992 report for description of this system), the won has depreciated against the dollar by 15 percent, due largely to higher inflation in Korea and the emergence of trade and current account deficits in 1990.

Foreign Exchange and Capital Controls

A broad array of controls on foreign exchange and capital account transactions in Korea continues to prevent market forces from playing a fully effective role in exchange rate determination, distorts trade and investment flows, and constitutes a potential channel for Korean monetary authorities to influence the exchange rate.

The so-called "real demand rule," which requires foreign exchange banks to obtain and review documentation of an underlying commercial transaction for most foreign exchange transactions, continues to impede the development of the Korean foreign exchange market and financial sector as a whole. Korea's restrictive terms for deferred import payment, especially regulations that limit payback periods to only a fraction of international norms, continue to be of key concern, as are tight restrictions on off-shore financing alternatives. While there have been a few limited steps since the fall 1992 report to ease controls in some of these areas, much remains to be done to enhance the role of market forces in the determination of the exchange rate and trade and investment flows. Reaching the Korea's stated goal of integrating the Korean financial sector into global capital markets will require the Korean authorities to take bolder steps toward shortening significantly the list of prohibited foreign exchange and capital transactions and to move forward with broad-based reform of the financial sector.

Status of Financial Policy Talks

Although no formal Financial Policy Talks (FPT) have been held between Treasury and Ministry of Finance officials since the last report, informal dialogue has continued as Korea moves toward completion of the Financial Sector Liberalization Blueprint (FSLB) announced in the March 1992 FPT (see fall 1992 report for further discussion). A parallel package of reform measures to deregulate the domestic financial industry is under formulation as well. While the two plans overlap in a number of key areas, the FSLB addresses to a greater extent issues relating to increased market access and other aspects of the internationalization of Korea's financial sector. The final measures of both plans will be incorporated into Korea's "Five Year New Economy Plan," slated for completion in June 1993.

Treasury's assessment of Korea's reform efforts will focus on both the substance and timing of the implementation of policies which target the lifting of foreign exchange and capital controls; liberalization of interest rates; elimination of directed credit schemes;

adoption of indirect means of monetary control; further opening of the stock market to foreign investment; and enhancement of local currency funding sources for U.S. and other foreign financial institutions operating in Korea.

CHINA

As China maintains significant restrictions on all aspects of foreign exchange activity in China, it is Treasury's judgement that China manipulates its foreign exchange system by restricting imports and that this action impedes effective balance of payments adjustment. Of particular concern are China's priority list of permissible imports and restrictions on access to foreign exchange. Moreover, China maintained a global current account surplus in 1992 and a large bilateral trade surplus with the United States. There have been no significant changes in China's foreign exchange system since the December 1992 Exchange Rate Report to Congress.

Trade and Economic Developments

China's global trade and current account surpluses remain substantial although they continued to fall in 1992. China reported that merchandise imports rose 26 percent in 1992 to $80.6 billion while merchandise exports rose 18 percent to $85 billion. As a result, according to Chinese figures, China's merchandise trade surplus dropped from $8.2 billion in 1991 to about $4.4 billion in 1992. Rapid import growth was fueled by strong domestic demand and rapid growth of GDP. China's smaller trade surplus contributed to a decline in China's current account surplus from $13.3 billion in 1991 to a reported $6.4 billion in 1992. Reserves increased by $2.6 billion to reach $46.9 billion in September 1992, about 7 months of import cover.[2] China's current account surpluses have allowed China to meet its debt service obligations with ease. While China's total external debt increased from $60.6 billion in 1991 to $69.3 billion in 1992, its debt service ratio has remained at about 11 percent.

China's bilateral trade surplus with the United States continued to grow rapidly in 1992. According to U.S. data, Chinese exports to the United States increased 37 percent to reach $25.7 billion. Toys, sporting goods, clothing, and footwear continue to be the largest categories of Chinese exports. Chinese imports from the United States rose 19 percent to reach $7.5 billion. Aircraft, fertilizers, measuring equipment, and wheat were the largest

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[2] In December 1992, Chinese authorities announced they would change the method used to calculate China's official reserves. Henceforth, foreign exchange held by the Bank of China will not be included in official reserves since it represents the deposits of state enterprises in the Bank of China (a bank controlled by the central government which specializes in foreign exchange transactions). According to the new calculations, China's official reserves for September 1992 would fall from $46.9 billion to $25.0 billion. With the central authorities maintaining a high degree of control over the use of funds held by enterprises in the Bank of China, the higher figure would be more appropriate.

categories of imports from the United States in 1992. China's trade surplus with the United States rose from $12.7 billion in 1991 to $18.3 billion, an increase of 44 percent. In 1992, China had the second largest trade surplus with the United States after Japan. U.S. Commerce Department information for January-March 1993 indicates that China's trade surplus with the United States increased $0.8 billion over January-March 1992.

In other economic developments, China's economy grew at an estimated annual rate of 12.8 percent in 1992. Chinese economic growth was spurred by a reform drive early in 1992 and by rapid increases in investment and the money supply. Investment in fixed assets jumped 38 percent over a year earlier while M2 increased 31 percent. In addition, China's domestic saving and investment rates remain high. In 1992, gross national savings stood at 36 percent of GNP while gross domestic investment stood at 34 percent. China's high level of national savings has allowed the country to maintain modest current account surpluses while investing a large portion of GNP. Chinese inflation remained a reported 5.4 percent in 1992, although it appears to be accelerating. The end of period inflation rate was over 7 percent while urban inflation reached 12 percent in 1992.

In the future, the Chinese economy faces a real threat of economic overheating unless the authorities take steps to prevent excessive growth of the money supply and investment. So far the Chinese authorities have not taken such steps. High economic growth continues to affect China's external sector, with preliminary indications that rapid growth in imports may substantially diminish China's trade and overall current account surpluses in 1993. According to Chinese trade figures for January-March 1993, China's imports rose 25 percent over the same period a year earlier while China's exports rose only 7 percent, leaving a global trade deficit of $1.2 billion.[3] But this cyclical development does not provide the promise of correction of the underlying structural imbalances sustained, in part, by distorted exchange markets.

China's Foreign Exchange System

China operates a dual exchange rate system. The official exchange rate is set daily and generally applies to priority imports for state enterprises under the State Plan. China's second exchange rate, the "swap" rate, is determined in foreign exchange adjustment centers. Joint ventures, foreign invested enterprises, and domestic trading firms with access to foreign exchange may buy and sell foreign exchange and foreign exchange quotas at the swap centers. Swap center rates are established through an open bidding system (15 centers) or as the State Administration of Exchange Control matches applications for foreign exchange (approximately 85 centers).

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[3] Chinese trade figures appear to be undergoing revision. The same trade report indicated a 32 percent drop in exports to Hong Kong and a 97 percent increase in exports to the United States. Changes in Chinese rules of origin and statistical methods may account for part of the change in trade figures.

China continues to maintain extensive restrictions on access to foreign exchange. For goods on the restricted list, an enterprise must receive a license from the Ministry of Foreign Trade and Economic Cooperation (MOFTEC)[4] before it may buy foreign exchange in the swap centers. For those goods that do not require MOFTEC approval, access is based on a priority list of uses of foreign exchange drawn up in conformity with state industrial policy. The authorities generally discourage purchases of foreign exchange to finance imports of goods not formally approved by the government. In April 1992 the authorities issued new guidelines outlining priorities for access to foreign exchange in the swap centers. Preferred access was given to those purchasing foreign exchange for agricultural inputs and products, interest payments and remittances, technology imports, and inputs to key construction projects. Access to swap centers was also granted for purchases of foreign exchange for industrial inputs, educational materials, and some spare parts. Purchases of foreign exchange for a wide range of consumer and luxury goods (cigarettes, wine, clothing, household appliances, and film) are prohibited. These limits on access to the swap centers act as barriers to trade since importers cannot purchase foreign exchange to import a wide range of goods.

Treasury's November 1991, May 1992, and December 1992 Reports to Congress contain additional detail on China's foreign exchange system.

Exchange Rate Developments

Since 1980, the Chinese currency has experienced substantial depreciations against major currencies. From 1980 to 1992, the renminbi (as measured at the official exchange rate) depreciated 73 percent versus the U.S. dollar, 85 percent versus the yen, and 71 percent versus the ECU. The depreciation of China's exchange rate has improved China's trade and China's current account positions. In particular, the devaluations of 21 percent in 1989 and 10 percent in 1990 helped China move from a current account deficit of $4.3 billion in 1989 to a current account surplus of $13.8 billion in 1991.

Administered Rate: On May 14, 1993, the official rate of the renminbi stood at 5.74 yuan/dollar. This represents a nominal depreciation of 7.8 percent since the adoption of the "managed float" system in April 1991. In 1992, authorities held the official rate relatively constant from January through August, but allowed the rate to depreciate towards the end of the year. By December 31, 1992, the official exchange rate had depreciated 5.5 percent over a year earlier. For the first three months of 1993, the official exchange rate has remained relatively constant at approximately 5.75 yuan/dollar.

Swap Rate: For the week ending May 14, 1993, the average swap center rate stood at 8.04 yuan/dollar. The swap rate depreciated 23.5 percent in 1992 due largely to increased demand for imports, rapid monetary growth, fears of renewed inflation, and speculation that

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[4] Formerly the Ministry of Foreign Economic Relations and Trade (MOFERT).

the Chinese authorities would devalue in preparation for entry into GATT. In 1993, the renminbi reached a low of 8.41 yuan/dollar in February and has since appreciated slightly to 8.04 yuan/dollar. This represents a depreciation of 10 percent since year-end 1992. It appears the Chinese government has intervened in the swap centers to prevent further depreciation of the currency.

The gap between the official and swap center exchange rates has continued to widen, from 10 percent in January 1992 to 40 percent on May 14, 1993.

Exchange Rate Negotiations

Treasury held negotiations with the People's Bank of China in April 1993. In these negotiations, Treasury urged the Chinese to improve access to foreign exchange. In particular, Treasury urged Chinese officials to lengthen the list of imports for which foreign exchange is available and to commit to a timetable for reform. Treasury also urged Chinese officials to move quickly to full current account convertibility, on the ground that such action would eliminate the need for the highly regulated foreign exchange allocation system now in place, which was driving foreign exchange trading to the informal market. These reforms would benefit the Chinese economy more broadly by improving economic efficiency, while addressing many of the U.S. concerns. Once such reforms were undertaken, market forces would then play a greater role in determining the exchange rate response to developments in the external payments position.

Treasury believes that foreign exchange restrictions form an integral part of China's overall trade regime. As such, these restrictions cannot be separated from larger trade questions affecting U.S.-China economic relations. Easing restrictions on access to foreign exchange would represent a step toward liberalizing China's trade regime, reducing the bilateral trade imbalance, and improving economic relations between China and the United States.

In 1992, China began more serious preparations for entry into the GATT. Treasury believes that China's accession to the GATT would be a positive step toward integrating China into the international economic community and beneficial for both China and the United States. Treasury notes that GATT Article XV contains two obligations with respect to exchange restrictions: 1) that GATT members shall not, by exchange action, frustrate the intent of the GATT trade provisions; and 2) that members may apply exchange restrictions only in accordance with the Fund Articles. As it accedes to the GATT, China must bring its exchange system into conformity with GATT Article XV and the IMF Articles of Agreement.

Assessment

While China has committed itself to reform of its trade regime in the context of the market access Memorandum of Understanding (MOU) and GATT, similar commitments have

not been made with respect to its foreign exchange system. Chinese officials have expressed general support for reform of the system, including: eliminating the requirement for surrender of foreign exchange, liberalizing access to the swap centers, and making the system more transparent. Chinese authorities have also set forth the long-term objectives of unifying the dual exchange rates and making the currency convertible. However, they have not indicated the specific nature of the steps they plan to take, and have not committed to specific measures or the timing of reform.

While China's current account surplus may diminish in 1993, its foreign exchange restrictions continue to impede balance of payments adjustment and contribute to large bilateral trade surpluses. In 1992 and early 1993, no significant changes were made in China's foreign exchange regime, and the authorities continue to maintain limits on access to foreign exchange. Therefore, it is Treasury's judgement that China is manipulating its foreign exchange system in a manner that prevents effective balance of payments adjustment within the meaning of Section 3004. We urge the Chinese authorities to take steps to liberalize access to foreign exchange by eliminating the pervasive foreign exchange restrictions that impede the external payments adjustment process.

ASIAN NIES AND CHINA: TRADE AND CURRENCY CHANGES

Cumulative Change against US$ as of May 19, 1993 [1]

Since:	(Plaza) 9/20/85	end–86	end–87	(Initial Report) 10/14/88	end–89	end–90	end–91	end–92
HK$	1.1%	0.8%	0.4%	1.1%	1.0%	0.9%	0.7%	0.2%
Won	11.7%	7.5%	–1.1%	–11.3%	–15.3%	–10.6%	–4.5%	–1.2%
Singapore$	36.4%	34.4%	23.5%	25.2%	17.7%	7.7%	0.4%	1.9%
NT$	56.1%	36.8%	10.0%	11.3%	0.8%	4.4%	–0.8%	–2.1%
Yen	118.4%	44.0%	11.5%	14.0%	29.6%	22.4%	12.7%	12.6%
DM	78.0%	19.6%	–1.5%	11.3%	4.3%	–7.7%	–6.2%	–0.1%
Yuan	–48.1%	–35.0%	–35.0%	–35.0%	–17.3%	–8.8%	–4.8%	0.8%

Rate on 5/19/93	
HK$	7.73
W	801.10
S$	1.61
NT$	25.96
Y	110.85
DM	1.62
Yuan *	5.72

* *rate on 5/4/93*

1. [–] signifies depreciation against the U.S. dollar.

U.S. Trade Balance with Asian NIEs and China [2]

(U.S. $ billions)

	1985	1986	1987	1988	1989	1990	1991	1992	1992 Jan–Mar	1993 Jan–Mar
Hong Kong	–5.6	–5.9	–5.9	–4.6	–3.4	–2.8	–1.1	–0.7	–0.1	0.3
Korea	–4.1	–6.4	–8.9	–8.9	–6.3	–4.1	–1.5	–2.1	0.2	–0.5
Singapore	–0.8	–1.3	–2.1	–2.2	–1.6	–1.8	–1.2	–1.7	–0.4	–0.1
Taiwan	–11.7	–14.3	–17.2	–12.6	–13.0	–11.2	–9.8	–9.4	–2.3	–2.0
Total NIEs	–22.1	–27.8	–34.1	–28.2	–24.3	–19.8	–13.7	–13.9	–2.7	–2.2
China	0.0	–1.7	–2.8	–3.5	–6.2	–10.4	–12.7	–18.3	–3.4	–4.2
NIEs + China	–22.1	–29.5	–36.9	–31.7	–30.5	–30.3	–26.4	–32.1	–6.1	–6.4
Total U.S. Trade Bal.	–132.1	–152.7	–152.1	–118.5	–108.6	–101.7	–66.2	–84.3	–11.2	–20.6

2. U.S. customs value data, not seasonally adjusted.
Totals may not equal sum of components due to rounding.

INTERNATIONAL UNION OF ELECTRONIC, ELECTRICAL, SALARIED, MACHINE & FURNITURE WORKERS (AFL-CIO)

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668-3002

January 22, 1993

Dear Congressman LaFalce:

In a meeting I had with the owner and Vice-President of a small company that employs about 35 of our Members, an interesting point was brought up. This Company deals with a firm in Indonesia where the market for their particular products are about 4 times the size of the domestic market.

The President of this Company said that a strong dollar hurts his ability to compete, particularly with Japan. He gave this example a month ago:

$1.00 U. S. = 2044 Rupiah (Indonesia monetary unit)
and as of yesterday it was 2055 to $1 U. S.

The Company President urged us to contact our Representatives and bring this point home.

I would be very interested in your opinion on this issue and what your experience can tell us on the idea of promoting legislation toward this end, or implementing monetary policies that would result in a weaker dollar, thereby making our international competitive position better.

Very truly yours,

Michael J. Rusinek

Michael J. Rusinek
IUE International Rep.

MJR:rk

CC: John Cant
Lou Dudek
Walter Smith, L. 386 President

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